

FINANCIAL INSTITUTIONS

SBA Market Activity Declining

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Historically, the market for U.S. Small Business Administration (SBA) loans has been countercyclical to the market for private sector loans to small businesses. When the market has been tight for small-business lending and borrowers are unable to qualify for regular loans, there has been an increase in the number of SBA loans requested and funded. However, in the current tightened credit market, the number of SBA loans has also declined, and as a result, many small businesses are unable to find satisfactory credit. According to recent information from the SBA, the SBA 7(a) program is down 30 percent from last fiscal year, and the total number of SBA loans was down 50 percent from October 2007 to October 2008.

Declining factors

Many factors are contributing to the coordinated decline in conventional and SBA loans:

- Demand for loans is weak because of the generally pessimistic economic outlook.

- Banks are tightening underwriting standards due to the uncertain financial conditions.
- Credit standards and terms are tougher in the nontraditional and subprime markets.
- The prime lending market is constricting as banks re-evaluate their loan portfolios.
- The creditworthiness of borrowers has diminished because of lower sales and weaker cash flow. With weaker fundamentals, more applications are rejected.

In addition, small businesses are attempting to find ways to produce cash flow internally rather than obtaining funds they might have difficulty paying back in the future. And many creditworthy borrowers simply don't need credit when business expansion doesn't make sense and inventories are being reduced.

Prime rate or LIBOR rate?

A critical tool for increased participation by lenders in the SBA loan programs is the ability to market the SBA guaranteed loans to the secondary market, which is essentially frozen right now. Still, other factors are contributing to the secondary market slowdown. The only base rate available on SBA 7(a) loans is the prime rate; however, the rate used to raise capital by investors in the secondary market is typically the LIBOR rate. (LIBOR stands for "London Interbank Offered Rate" and is based on rates that contributor banks in London offer each other for interbank deposits.)

The prime rate has been significantly reduced in recent

months as the LIBOR rate has increased, resulting in fewer investors willing to buy SBA loans on the secondary market. Also, the secondary market only allowed pooling of loans with the same prime rate, effectively limiting the number of pools available.

To address the extraordinary market conditions limiting the credit availability for small businesses, the SBA issued an interim final rule, effective November 13, 2008, to make adjustments to the secondary market for SBA 7(a) loans. The rule will permanently add an additional LIBOR rate for lenders to use when pricing SBA 7(a) loans and will allow for secondary market loan pools to be formed using weighted average coupon rates (rates determined by weighting and averaging the rates of the different segments of a loan pool).

The emergency measures by the SBA should help bolster the market for SBA loans but will not eliminate the pessimism affecting the economy and the uncertainty in the markets. Unless other measures are enacted to make the SBA loan programs more attractive to small businesses, the numbers will likely remain low, and small businesses will continue to face uncertainty in 2009.

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