2019 SBA 7(a) Loan Market Outlook

Opportunities Arise in the Midst of Stabilizing SBA Market

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WINDSOR ADVANTAGE

I. Introduction

Welcome to our 2019 SBA 7(a) Loan Market Outlook, an annual forecast of key market dynamics based on the best data available at the time of publication. Just as our strategic discussions with lenders and industry experts naturally focus on the SBA loan marketplace's current state and future trends, this report aims to capture the same forward-looking, proactive views as a foundational tool for its readers. We hope you find this tool educational, practical and useful, and continue to reference this document as your own 2019 SBA market outlook may evolve throughout the year.

Small-businesses are the primary jobs engine of the U.S. economy — [1]creating two out of three net new private sector jobs each year. The Small Business Administration (SBA) helps small-businesses drive a healthy economy through a number of initiatives — including the flagship 7(a) loan guaranty program — designed to encourage lenders to provide loans to small-businesses that are often unable to secure financing on reasonable terms or conditions elsewhere.

Four main themes appear to be defining the SBA lending market in 2019:

- Approved Dollar Volume Remains Near Record Level
- Active Lender Participants Reaches Lowest Level in 12 Years
- SBA Lender Oversight Continues to Strengthen
- Secondary Market Premiums Rebound From 2018 Lows

Approved Dollar Volume Remains Near Record Level

As shown in the chart below, the SBA achieved a near record level of approved dollar volume in FY2018, approving $25.37 billion, $80 million less than FY2017. This 0.3% decrease in the dollar volume represents the first time year-over-year 7(a) growth has not occurred in five years.

However, FY2018 still marks the second highest amount of 7(a) approvals in the program's history and is more than two times the amount approved in FY2010. This significant 7(a) volume trend may be attributed to economic expansion but much of this sustained volume is more likely due to the increasing focus on technology by the top SBA lenders.

[1] *2019 Budget Justification – p. 2; Small Business Administration*

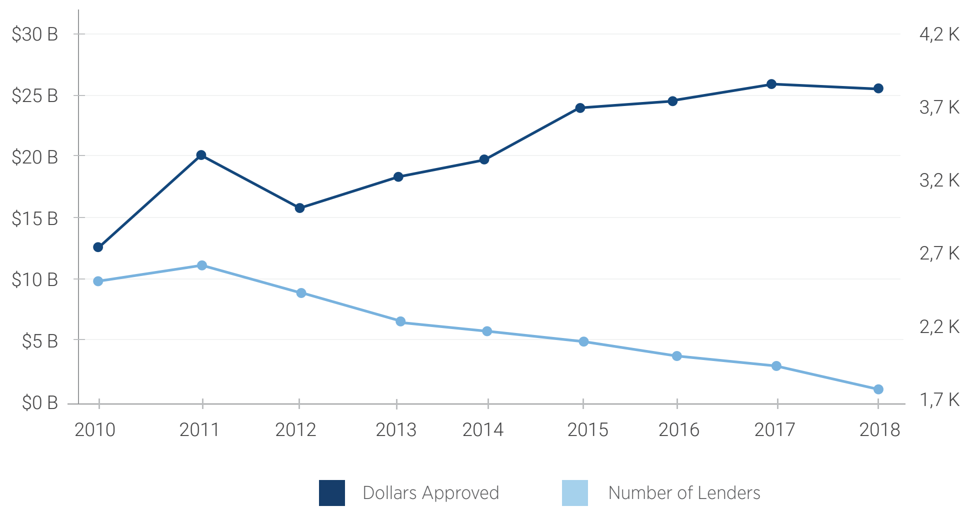
Active Lender Participants Reaches Lowest Level in 12 Years

While total dollar volume remains near record highs, the number of lender participants in the SBA 7(a) Loan Program continued to drop from a highpoint of 2,728 in FY2011 to 1,810 in FY2018 — the lowest level in 12 years. The top 50 lenders by volume provided more than 53% of all SBA 7(a) loans in both FY2017 and FY2018. [2] The continuing trend of decreasing participants, coupled with substantial dollar volume growth is what Windsor refers to as the "Sophistication Gap".

As community lenders continue to retreat from the program, more and more sophisticated, 7(a) specialty bank and non-bank lenders dominate a majority of the market. In addition to the widening gap, the average loan size continued to trend upwards to $420,401, an increase of more than 3% over the prior year and 14% over the previous five years. [2] And if Q1 of FY2019 is any indication — the four months ended January 31, 2019 — the increasing average loan size looks likely to continue, currently hovering around $480,000 for FY2019. Technological shifts such as marketing automation, marketplace lending, automated credit decisioning models and the increased focus on technology at the SBA, may also positively impact volume going forward.

And if Q1 of FY2019 is any indication — the four months ended January 31, 2019 — the increasing average loan size looks likely to continue, currently hovering around $480,000 for FY2019.

Dollar Volume Remains High While Number of Active Lender Participants Continues to Drop



SOURCE - Small Business Administration [2]

[2] *Small Business Administration – SBA 7(a) Loan Data Reports*

SBA Lender Oversight Continues to Strengthen

By amending the Small Business Act, Capitol Hill has communicated a clear message – SBA volume and all third-party involvement has increased – and a focus on oversight is here to stay. Windsor, and many of its fellow National Association of Government Guaranteed Lender (NAGGL) members, were active participants in the support of the 7(a) Lending Oversight Reform Act as the legislation encouraged compliant and proper use of the program, thereby protecting its sustainability.

Secondary Market Premiums Rebound From 2018 Lows

During 2018, we experienced some of the largest drops in secondary market premiums in years, with 10-year fully priced SBA 7(a) premiums swinging nearly 340 basis points between Q2 and Q4. The latest drop in premiums can be attributed to a mix of factors, the most impactful being the dramatic increase in prepayment speeds in Q4 of 2018. While the reason for the significant increase in 7(a) prepayments isn't isolated to a single variable, two major factors related to existing borrower characteristics will be addressed at a later section.

II. Impact of the Small Business 7(a) Lending Oversight Act

Mike Breckheimer, President & CEO

On January 9, 2018, the House Committee on Small Business, led by Chairman Nydia M. Velázquez (D-NY) introduced the Small Business 7(a) Lending Oversight Reform Act of 2018. The act was a bipartisan legislation focused on protecting the integrity of the program through implementing additional controls aimed at protecting tax payer dollars. The common tone within the bill centered around empowering both the SBA and its primary oversight arm, the Office of Credit Risk Management (OCRM), and was positively received by both sides of Capitol Hill, as well as the SBA community despite its overall objective to increase regulatory oversight of lenders participating in the program.

The anticipated legislation was passed in the House in May, the Senate in June, and signed by the President, thereby becoming [3] Public Law No.: 115-189 on June 21, 2018.

The bi-partisan Bill amended the Small Business Act and provided future statutory authority for both the SBA and OCRM, achieving four major objectives:

- Strengthened the framework of the SBA's OCRM by further defining the responsibilities of the office and the requirements of its director
- Enhanced the SBA's lender oversight review process, including increasing OCRM's enforcement options (e.g. removing a Lender's Delegated Authority (PLP) status)
- Required the federal agency to detail its oversight budget, and required a full risk analysis of the program on an annual basis
- Strengthened the "Credit Elsewhere Test"

By amending the Small Business Act, Capitol Hill has defined a clear message with a focus on lender oversight. However, while supportive, Windsor recognizes that increased program oversight translates to more time, money and effort for lenders and 2019 will be a year to focus on program and process compliance. Completing the proper reviews, implementing necessary controls and preparing for increased regulatory oversight are all critical measures lenders should build into their 2019 SBA department strategies.

[3] *Congress.gov – Small Business 7(a) Lending Oversight Reform Act of 2018*

III. Secondary Market Sales Outlook

Mike Breckheimer, President & CEO

Barring any unforeseen market events, 2019 will more than likely be a year of slow but positive movement for SBA 7(a) and USDA secondary market premiums. Last year, we experienced some of the largest drops in secondary market premiums in years, with 10-year fully priced SBA 7(a) premiums swinging nearly 340 basis points between Q2 and Q4 of 2018.

The drop in premiums can be attributed to a mix of factors, the most impactful being the dramatic increase in prepayment speeds in Q4. Constant Prepayment Rate (CPR) is the measure of loan prepayments as a percentage of the current outstanding loan balance and is the key indicator for tracking the performance of SBA 7(a) pools. In October of 2018, prepayment speeds (CPR) reached nearly 20%, the highest level in years. [4] To place a 20% CPR in perspective, CPR in November of 2017, after being adjusted for Colson's 2017 change in pass-through principal payments, was nearly half this rate at 12.45%.

While the reason for the recent significant increase in 7(a) prepayments can't be isolated to a single variable, two major factors more than likely contributed to the increase in CPR over 2018.

Strengthening Economy Causing More Refinancing Opportunities (Impact: Strong Borrowers)

The United States continues to near the longest economic expansion – [5]currently 116 months – in the country's history. A direct impact of a strengthening economy is a strengthening borrower base. Businesses which climbed out of the great recession through the use of SBA financing have continued to prosper as the economy has strengthened. Those same businesses have reaped the benefits of artificially deflated rates due to quantitative easing and are in turn now more bankable than ever and have likely graduated from SBA to more conventional products.

Increase in Base Rate Causing More Refinancing Opportunities and Defaults (Impact: All Borrowers)

The majority of SBA loans sold in the secondary market are structured as variable rate loans, indexed off Wall Street Journal Prime. Wall Street Journal Prime correlates directly with the Fed Funds Target Rate.

[4] *Government Loan Solutions – The CPR Report*

[5] *Seeking Alpha – Length of Economic Expansion*

[6] Recently, the Central Bank has become the most hawkish it has been since 2005, increasing its target Federal Funds Rate over seven separate occasions in the last two years, resulting in Wall Street Journal Prime increasing 175 basis points. This increase in the base index has significantly increased 7(a) loan payments for borrowers on variable rate structures - the majority of guarantees sold to the secondary market.

Additionally, higher required payments resulting from a 175 basis point increase in interest rates over a two-year period is putting pressure on borrowers who were not able to take advantage of this economic expansion in time or are considered start-ups out – defined as younger than two years.

SBA 7(a) Premium Data

Loan premiums are not widely published. This often makes it difficult for many lenders to ensure they are getting the highest secondary market premium. To be more competitive, lenders should prepare bid sheets and submit the opportunity to no less than eight investors. Only through experience can lenders gain current knowledge of the most active investors and the highest premiums based on the structure of each loan.

Demand for quality, guaranteed, variable rate assets will continue to bolster the 7(a) and USDA secondary markets, regardless of pre-payment speeds. Based on a sample of more than $420 million in government guarantees sold through Windsor's platform in calendar 2018, the table below shows bids on 25-year loans were as high as 117.935 and bids on 10-year loans were as high as 111.825.

Term	Spread	High	Low
25 Year	P + 2.75%	117.935	112.789
10 Year	P + 2.75%	111.825	106.159

SOURCE: Windsor Advantage

Lender-controlled Factors to Consider

Several factors impact the level of secondary market premiums. Market forces such as supply and demand and changes in interest rates cannot be controlled by lenders, but the following lender-controlled factors should be considered when structuring loans and estimating potential premiums:

[6] *Board of Governors Federal Reserve System – Open Market Operations*

- **Time** — 10-year loans should be bid to the secondary market immediately upon full disbursement and at a maximum, within thirty (30) days of funding in order to garner the highest secondary market premium. 25-Year loans should be bid within the first sixty (60) days.
- **Term** — Longer terms receive higher premiums. 25-year terms result in a higher premium than 10-year terms.
- **Spread** — Maximum spread over prime is 2.75% on loans over $50,000. Maximum spreads receive the highest premium.
- **Adjust** — Quarterly and monthly adjusts receive the highest premiums, versus annual adjust and fixed rate loans.
- **Size** — The size of the loan impacts the premium, with larger loans receiving less premium.

According to discussions with the largest SBA loan poolers, approximately 40% of all 7(a) loans are sold into the secondary market and 90% of the sold loans are poolable vs. non-poolable. There are slightly more 25-year loans than 10-year, and 85% adjust quarterly. [7] Per the SBA, in FY2017, the amount of loans sold on the secondary market totaled approximately $9.4 billion, a near-record amount of volume. While 2018 data has yet to be published, discussions with Colson and the secondary market community estimate 2018 volume near 2017 levels.

2019 should mark a gradual increase from last year's 7(a) premium figures as the Fed has provided guidance indicating only gradual rate hikes for 2019 , with two projected compared to four in 2018. Theoretically fewer rate increases translates to a lower number of Prime Rate increases, thereby slowing prepayment speeds and increasing 7(a) premiums. However, as secondary market volume and 7(a) program authorizations remain at record levels in 2019, lenders should increase focus on secondary market settlement compliance as an increase in secondary market income will undoubtedly – and for good reason – heighten regulatory oversight of the program and those electing to sell guaranteed loans in the secondary market.

[7] *Small Business Administration – Agency Financial Report FY2018; p. 104*

IV. Impact of Latest Changes to the SOP 50 10 5

Will McClain, Managing Director

Effective April 1, 2019, the SBA has issued the new SOP 50 10 5(K) for participating lenders. For the most part, changes have memorialized concepts that were introduced in a notice issued early in 2018. There are, however, a few changes and clarifications that will affect the way SBA lenders participate in the program going forward:

- Change of Ownership Debt Refinance
- Explicit Acknowledgement of Term Extensions
- Clarifications for Businesses Operating Under Multiple Agreements

Change of Ownership Debt Refinance

The increase in prevalence of online lenders providing short term, quick financing to borrowers could provide an opportunity for lenders familiar with general processing.

The SBA has altered the requirement on how long a lender must wait before they can refinance debt originally used to finance a change of ownership under delegated authority. The SBA has extended the required wait period from 6 months to 12 months before being eligible for refinance. Lenders will still be allowed to submit a loan that does not qualify under the required timeline to the Loan Guaranty Processing Center (LGPC) for review, but this will likely deter some lenders. The increase in prevalence of online lenders providing short term, quick financing to borrowers could provide an opportunity for lenders familiar with general processing. Many of the loans provided in short turn-times also carry higher interest rates and accelerated terms. Lenders able to properly identify and process these loans could benefit with the ability to refinance loans under SBA terms well before lenders utilizing delegated authority.

Explicit Acknowledgement of Term Extensions

While many lenders have submitted leasehold improvement loans to the LGPC for approval and received a similar opinion, the SBA added clarification to the SOP on how to deal with loans that have an extended construction period. This provides guidance for delegated lenders to allow for an extra term of up to 12 months on larger leasehold products. In many cases, this will allow borrowers more time to complete projects and get up and running before having to make full debt payments. This should provide much needed flexibility for many start-up and expansion borrowers to succeed.

Clarifications for Businesses Operating Under Multiple Agreements

While many are familiar with large name brands (e.g. Dunkin Donuts and Subway), many small-businesses operate with multiple brands or license agreements that require the scrutiny of lenders to ensure the business is truly independent. With the SOP changes effective January 1, 2018, the SBA unveiled the Franchise Directory aimed at simplifying the review of these agreements. While the Directory has helped increase efficiencies, the SBA was not entirely clear on how to proceed when agreements were present but may not have been material to the operation of the business.

In the new iteration of the SOP, the SBA clarifies how lenders can reduce the overall paperwork for borrowers by focusing on agreements considered material or critical to the operation. The SBA has defined this as any single agreement or all agreements equaling at least 50% of the revenue generated by the borrower. For all critical agreements, the lender must obtain the required addendum listed on the Directory but can avoid the collection of the same addendum for non-critical agreements as long as they are listed on the Directory. This should help lenders streamline processes for those businesses with multiple agreements to review.

While each of the above will affect how lenders use the program in 2019, the SBA also took the opportunity in this issuance of the SOP to add important clarifications provided via notice to the full regulations. Some examples of these items include the updates to the personal liquidity analysis, clarification of partner buyout equity rules and clarification to the SBA's rules around lending to marijuana related businesses.

V. SBA Strategy

Andrew Sheaffer, Vice President of Business Development

Identifying key markets and industries while maintaining robust risk management and compliance is critical for both operational and regulatory success.

Each institution must identify the best type of borrower for its culture and execute on how to most efficiently access that market. Identifying key markets and industries while maintaining robust risk management and compliance is critical for both operational and regulatory success. OCRM will continue to focus on identifying and managing the risk to the program.

To build a compliant and scalable SBA lending platform, lenders must first define their strategy — and then implement sufficient technology aligned to meet that strategy. In order for the SBA to meet its objective to drive increased lending by a larger number of lender participants, it is imperative that more lenders adopt a well-defined strategy supported by technology and a risk-aware culture.

To formulate a comprehensive strategy, lenders must answer eight questions:

- Why participate?
- Who are our competitors?
- What type of borrower fits our culture?
- Where will we lend?
- How will we originate?
- How will we compensate?
- How will we control risk?
- How can we evolve?

Why Participate?

Lenders should start by asking, "why do we want to participate in the SBA 7(a) Loan Program?" Some of the most popular reasons are to generate fee income, provide more favorable structures for borrowers (e.g. amortization, collateral coverage) and to assist underserved communities and/or achieve community reinvestment goals.

Who are the Competitors?

Next, lenders should ask, "who are our main competitors?" An understanding of local competitor footprints, target industries and origination strategies will help identify opportunities for success. The total percentage of local lenders that currently participate in the program, as well as the total dollar volume authorized by local lenders to serve local borrowers (especially for community banks) should be considered. A later section will provide a full analysis on several opportunistic states for SBA lending in 2019 based on metrics tied to local competition and increased SBA borrower demand in recent years.

What Type of Borrower?

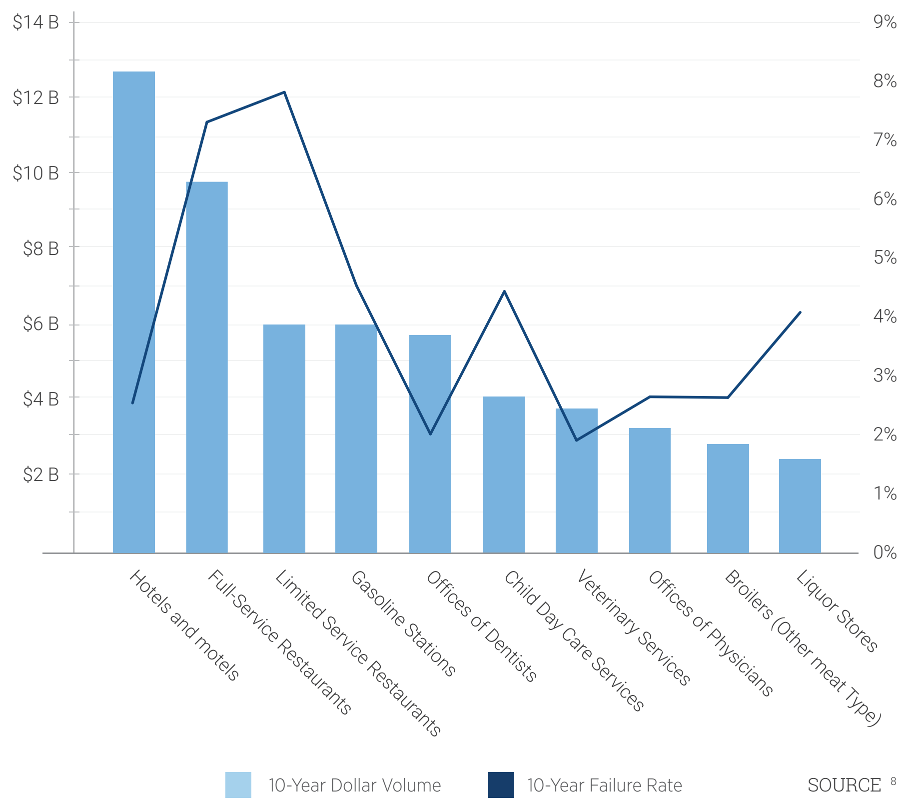
Thereafter, lenders should start to consider, "what type of loans do we want to fund?" Responses often include geographic focus and use of proceeds/asset class (e.g. business acquisitions, equipment purchase, real estate purchase, small loans). Industry focus is also an important consideration. The following table summarizes the types of small businesses with the largest number of SBA loans by dollar volume from January 1, 2008 to December 31, 2017 and the Failure Rates during this period. These top 10 industries represent 30.7% of all SBA loans by dollar volume over this 10-year period.

10-Year Total:
$181,201,295,442

Top 10 Total:
$55,543,310,952

These top 10 industries represent 30.7% of all SBA loans by dollar volume over this 10-year period.

SBA Loan Approvals - Top 10 Industries & Failure Rates



SOURCE [8]

[8] *Small Business Administration – SBA 7(a) Loan Data Reports*

Where will we Lend?

The SBA has outlined a priority goal to increase the number of loans by 5% from the FY2017 baseline in rural markets and HUBZones by September 30, 2019.

Defining your footprint is critical as referral sources and in-bound opportunities take time to review. Geographic boundaries must be defined up front. It's also important for lenders to keep in mind that the demand for access to capital for small-businesses in rural areas is at an all-time high. [9] The SBA has outlined a priority goal to increase the number of loans by 5% from the FY2017 baseline in rural markets and HUBZones by September 30, 2019.

How will we Originate?

Once the lender defines "why" they are participating in the program, "who" the competition is, "what" type of borrowers they seek and "where" they are going to lend, they must ask, "how will we originate these loans?"

Responses often include branch networks and internal business development, strategic partnerships, loan agents (e.g. loan brokers and investment bankers) and online or marketplace origination. As previously mentioned, technology decisions are playing an increasingly significant role in the competitive differentiation of origination activities by SBA lenders.

How will we Compensate for SBA Volume?

The next component is to determine how to compensate lenders and referral sources for SBA loan volume. Before marketing the program, lenders must define and communicate the compensation structure. Keep it simple and, most importantly, be consistent.

How will we Control Risk?

Perhaps most importantly, the lender must focus on identifying their risk, quantifying that risk and ultimately creating controls to mitigate that risk. Lenders should ask, "how will we control the risk, from both an operational and credit perspective?" Typical answers include developing a comprehensive risk assessment, creating detailed credit policies and operational procedures with controls by function and establishing accountability by measuring the results and reassessing risk ongoing.

[9] *Strategic Plan FY2018-2022 – p. 7; Small Business Administration*

How can we Evolve?

While very few banks and credit unions currently consider themselves a digitally mature leader, more than 60% aspire to be one by 2020.

Ultimate SBA department success will always remain in the basics of effective management but the impact of technology across commercial lending continues to change rapidly. [10] While very few banks and credit unions currently consider themselves a digitally mature leader, more than 60% aspire to be one by 2020. The competitiveness of the SBA marketplace, dominated by a small number of lenders providing more than half the total dollar volume, requires that remaining participants increase their technological sophistication to compete more effectively. A thoughtful strategy for the future that combines technology with efficient processes is the only path to staying ahead of the competition.

[10] *Thrive or Survive? Tech Strategies Will Determine Banks' Future – p 1; The Financial Brand*

VI. Opportunistic States for SBA Lending in 2019

Andrew Sheaffer, Vice President of Business Development

Although the SBA 7(a) Loan Program fell just short of its sixth consecutive year of overall growth this past year, there remain several outlier states that have continued to grow rapidly and present the greatest opportunity for local community banks to either enter the market and/or increase volume in 2019.

For the purpose of this section, the term "opportunistic" refers to states where local SBA competition is lower than the rest of the country as a whole **AND** the demand for SBA loans is increasing at a faster rate than the rest of the country as a whole. Consider the below metrics used to identify eight high potential markets in 2019:

- [11] **Least Competitive:** The percentage of FDIC insured institutions (as of September 30, 2018) that did not participate in the SBA 7(a) Loan Program during FY2018.

As seen in Table A., there are more than 1,000 FDIC insured lenders headquartered across these eight states that did not authorize a single SBA 7(a) loan during FY2018.

Table A

State	# Inactive SBA Banks	# Total HQ'd Banks	% Inactive SBA Banks
Louisiana	101	118	85.6%
Illinois	366	440	83.2%
South Carolina	43	52	82.7%
Maryland	42	54	77.8%
Colorado	69	88	78.4%
West Virginia	44	57	77.2%
Texas	337	444	75.9%
Florida	88	118	74.6%
Entire Country	3,945	5,477	72.0%

X - Axis

SOURCE [11]

[11] *FDIC.gov (State Profiles as of September 30, 2018)*

- [12] **Fastest Growing:** The percentage of SBA 7(a) loan dollar volume growth from combined data ranging from FY2015-2016 to FY2017-2018.

Table B

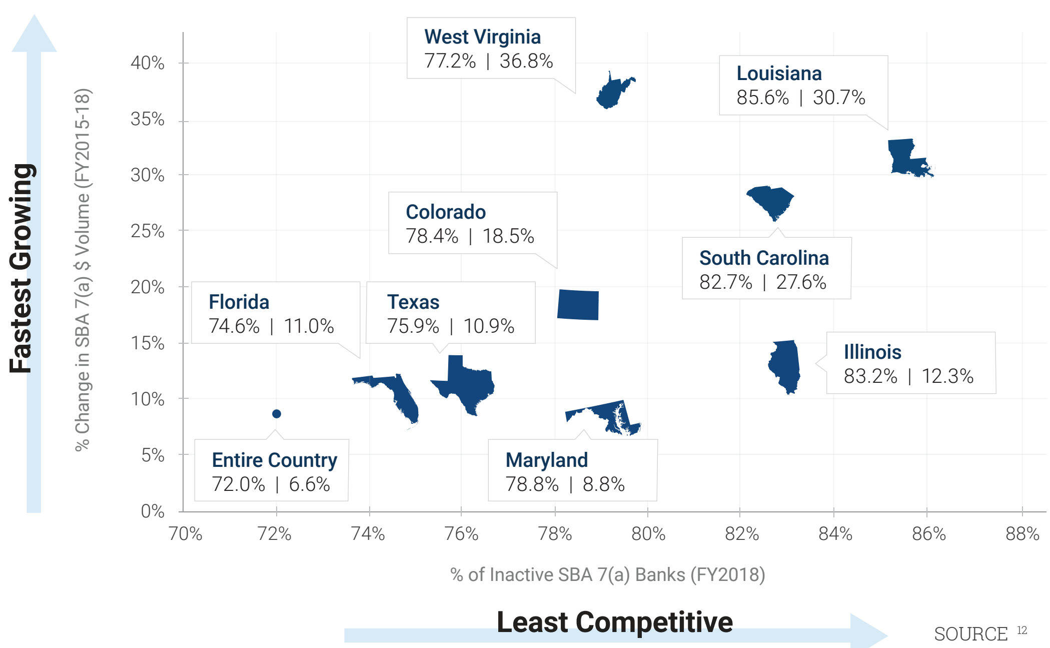
State	Combined FY15-16 $	Combined FY17-18 $	% Change in $ Volume
West Virginia	$63,907,900	$87,418,000	36.8%
Louisiana	$375,313,400	$490,675,800	30.7%
South Carolina	$523,277,600	$667,761,900	27.6%
Colorado	$1,259,405,900	$1,491,858,200	18.5%
Illinois	$1,566,173,400	$1,758,816,100	12.3%
Florida	$2,967,904,300	$3,294,072,600	11.0%
Texas	$4,743,005,600	$5,260,979,200	10.9%
Maryland	$57,217,800	$620,520,200	8.8%
Entire Country	$47,493,141,243	$50,641,737,000	6.6%

Y - Axis

SOURCE [12]

The following sections will provide a brief discussion on the SBA lending markets in Louisiana, Illinois, South Carolina, Texas, Florida, Maryland, Colorado and West Virginia. In addition to competition and growth takeaways, we've highlighted top counties, trending industries and regional education events to attend in 2019 for each of the eight states.

Top Opportunistic States for SBA Lending in 2019



SOURCE [12]

[12] *Small Business Administration – SBA 7(a) Loan Data Reports*

Louisiana

No other state in the contiguous United States grew SBA dollar volume year-over-year faster than Louisiana in FY2018. Volume increased by nearly 80%, reaching $314 million up from $175 million in FY2017. The next fastest growing state grew by 34% during this same period.

- **SBA FY2018 Top Counties** — East Baton Rouge ($40 million); Saint Tammy ($31 million); Jefferson ($28 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Broilers and Other Meats (#2 v. #11); Pharmacies (#4 v. #19); Engineering Services (#6 v. #33)
- **2019 Regional SBA Event** — NAGGL Annual Conference hosted by the National Association of Government Guaranteed Lenders in New Orleans, LA (October 28-30)

South Carolina

In FY2018, lenders domiciled in South Carolina authorized less than 7% of the total SBA 7(a) loan dollar volume used to fund small-businesses in the state. This percentage ranked as the lowest for any state in the country in FY2018, as the majority of states typically see anywhere from 25-50% of in-state volume authorized by in-state lenders in a given year.

- **SBA FY2018 Top Counties** — Greenville ($39 million); York ($35 million); Charleston ($31 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Self-storage Units (#4 v. #17); Marinas (#11 v. #137); Breweries (#12 v. #22)
- **2019 Regional SBA Event** — Southeast Small Business Lenders Conference hosted by the Georgia Lenders Quality Circle in Asheville, NC (March 13-15)

Illinois

With 440 banks headquartered in the state, Illinois ranks as the state with the second highest number of FDIC insured institutions in the country only behind Texas. Of the 74 banks that were active participants in the program in FY2018, roughly half authorized less than three SBA loans, leaving plenty of room for in-state lenders to grab hold of the increasing market share.

- **SBA FY2018 Top Counties** — Cook ($384 million); Dupage ($122 million); Lake ($92 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Long-distance Freight and Trucking (#6 v. #24); Funeral Homes (#12 v. #23)
- **2019 Regional SBA Event** — Great Lakes Lenders Conference hosted by the SBDC of Michigan in Detroit, MI (July 23-25)

Texas

The Lone Star State has grown overall SBA volume by nearly $500 million since FY2015, hitting $2.7 billion in FY2018. No other state in the country has a higher delta during this four-year span. With six different SBA district offices throughout the state, there are more than enough resources for local lenders to bolster even more SBA participation in 2019.

- **SBA FY2018 Top Counties** — Harris ($512 million); Dallas ($364 million); Tarrant ($246 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Car Washes (#4 v. #8); Automotive Repair Shops (#9 v. #14)
- **2019 Regional SBA Event** — Mid-America Lenders Conference hosted by the Central Texas Association of Government Guaranteed Lenders in Corpus Christi, TX (April 8-10)

Florida

Slow and steady growth has been the key to Florida making the list in 2019. Dating back to FY2013, the year-over-year dollar volume growth rate has exceeded at least 3% each year through FY2018. Furthermore, local lenders should see an opportunity to compete more effectively in FY2019, as the number of FDIC insured active SBA lenders dropped to 30 in FY2018 (down from 46 in FY2017).

- **SBA FY2018 Top Counties** — Miami-Dade ($233 million); Broward ($158 million); Orange ($130 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Physicians (#6 v. #13); Veterinarians (#7 v. #12); Insurance Agencies (#9 v. #21)
- **2019 Regional SBA Event** — FLAGGL Annual Conference hosted by the Florida Association of Government Guaranteed Lenders in Orlando, FL (September 18-20)

Maryland

SBA loan volume has grown in three consecutive years for Maryland small-business borrowers ($273 million, $299 million and $320 million respectively year-over-year). Growth, coupled with the decline in number of in-state SBA participating banks (17, 14 and 10 respectively year-over-year), makes Maryland a high opportunity state for community lenders in 2019.

- **SBA FY2018 Top Counties** — Montgomery ($54 million); Anne Arundel ($49 million); Prince Georges ($45 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Computer Programing (#9 v. #52); Industrial Buildings (#10 v. #151); Meat Wholesales (#11 v. #136)
- **2019 Regional SBA Events** — America East Small Business Lender's Conference in Mashantucket, CT (August 14-16)

Colorado

Since FY2013, SBA volume has grown rapidly in Colorado, up from $453 million to $731 million in FY2018. This 61% increase in dollar volume is nearly 20% higher than the growth the rest of the country experienced as a whole during this same period ($17.7 billion in FY2013 to $25.3 billion in FY2018, yielding roughly 42% growth in dollar volume for the entire country).

- **SBA FY2018 Top Counties** — Denver ($139 million); Arapahoe ($88 million); Jefferson ($83 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Liquor Stores (#2 v. #19); Breweries (#10 v. #22); Automotive Maintenance (#16 v. #34)
- **2019 Regional SBA Event** — America West Small Business Lender's Summit in Palm Springs, CA (June 11-13)

West Virginia

While West Virginia represents far less overall production volume than the other states highlighted in this section, the state has experienced the fastest growth as a percentage of in-state volume from combined data ranging from FY2015-2016 to FY2017-2018 with more than 36%. Substantial growth in the state can be attributed to the increased focus on lender training conducted by the local SBA District Office, which has earned a strong reputation for its webinar events in recent years.

- **SBA FY2018 Top Counties** — Kanawha ($7.2 million); Monongalia ($6.7 million); Lewis ($5.1 million)
- **SBA FY2018 Outlier Industries (State v. National $ Volume Rank)** — Veterinarians (#2 v. #12); Pharmacies (#3 v. #19); Investment Advice (#11 v. #35)
- **2019 Regional SBA Event** — SBA District Office Remote Training Schedule

As seen in Table A., there are more than 1,000 FDIC insured lenders headquartered across these eight states that did not authorize a single SBA 7(a) loan during FY2018. It's important for community lenders in these states to recognize that more and more local small-businesses are utilizing the SBA 7(a) program in their area and an assessment on whether or not it makes sense to enter the market in 2019 should at least be considered.

VII. Other Trends and Statistics

A. Processing & Closing

William McClain, Managing Director

Application packaging and SBA-compliant loan closing is a time consuming and often frustrating process. To be successful, lenders must prepare and submit complete and accurate application packages as efficiently as possible. Understanding how the top lenders effectively drive volume and becoming familiar with the latest loan processing rule changes are critical components to achieving efficiencies and subsequently driving volume.

With another strong year of loan volume, several trends continue to emerge among the top 50 lenders in the country.

Top 50 SBA Lender Trends

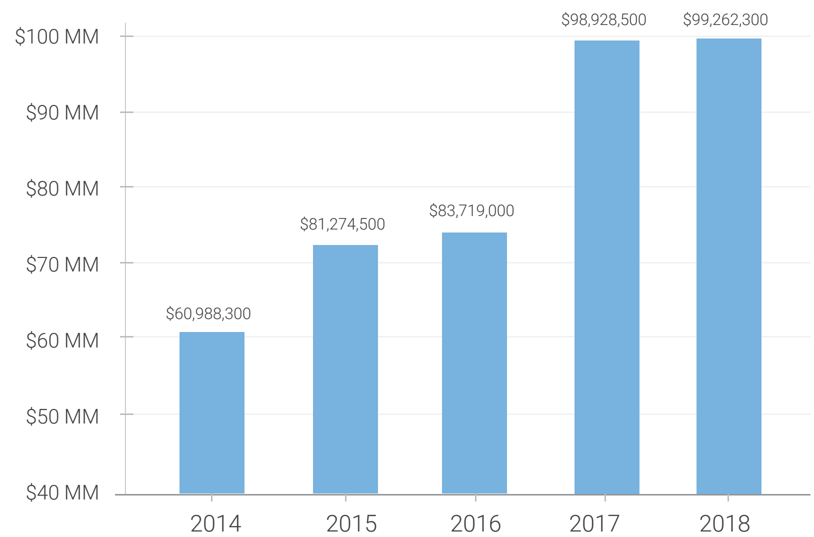
Five years ago, a lender had to authorize approximately $60 million in SBA 7(a) loans to make the list. The amount of volume has now grown by about 62% to $99 million.

The loan volume to be a top 50 lender has significantly increased since FY2014. Five years ago, a lender had to authorize approximately $60 million in SBA 7(a) loans to make the list. The amount of volume has now grown by about 62% to $99 million. Undoubtingly, the top 50 lenders continue to increase volume year-over-year and looking to this group can help provide insight into what the most efficient lenders in the country do to grow volume.

As discussed in a recent **Windsor blog**, the average loan size has now increased in each of the previous five fiscal years. However, when focusing on the top 50 lenders, the average loan size has actually decreased slightly year-over-year in FY2018, dropping to $381,867 from $383,820 in FY2017. This suggests that the largest lenders in the market have found a way to effectively serve borrowers with a need for less capital in an efficient manner. In fact, looking at the total number of loans authorized during FY2018, the top 50 lenders have accounted for 53.2% of the total dollar volume and 58.6% of the total units. The SBA has been encouraging smaller loans for a long time and it would appear the top lenders are leveraging improved efficiencies and technology to answer the call.

When looking at the overall trend in market volume, we are finally seeing year-over-year volume growth level out, suggesting greater consistency across the market. Based on Q1 data for FY2019, we anticipate volume to follow a similar path to that of FY2018, and with the government shutdown, decreases are even more likely to occur. The expected stabilizing of volume follows a similar pattern to that of number of lenders participating in the program.

Volume Threshold - Top 50 Lenders



SOURCE [13]

From FY2017 to FY2018 the market lost approximately 8.5% of participating lenders. Whether due to mergers and acquisitions or lenders voluntarily exiting the market, it provides another reminder that SBA lending is becoming more of a "specialist" playing field each year.

As top lenders focus on smaller transactions, overall volume stabilizes and fewer lenders participate in the program, competition among lenders seeking eligible borrowers will likely increase, forcing more lenders to find a niche to effectively serve their customers.

2019 Processing Rule Changes

In 2019 we expect to see more rule changes that will impact how participating lenders participate in the program over the next 12 months. In Q3 of FY2018, the Office of Financial Assistance (OFA) offered lenders a view into some proposed rule changes that may go into effect in 2019.

While there are a number of changes included in the rule, there are three that will have the most significant impact on the 7(a) Loan Program in 2019:

- Personal Liquidity Rule
- Allowable Borrower Fees from Lenders
- Affiliation Updates

[13] *Small Business Administration - SBA 7(a) Loan Data Reports*

Personal Liquidity Rule

While the SBA has increased focus on evaluating the liquidity of guarantors for the Credit Elsewhere test, they stopped short of giving concrete guidance on exactly what lenders must identify. This has caused some lenders concern that the methodology used to evaluate liquidity and its impact on Credit Elsewhere may not line up directly with what the SBA believes.

To help with this concern, the SBA has proposed to put a new rule in place that gives explicit guidelines for how to look at liquidity. The rule mirrors a similar structure to the liquidity test that was eliminated years ago. While some lenders appreciate the clarity, initial feedback suggests that many believe the rule used in the past was eliminated for a reason and that the lack of consideration for cost of living and individual business and personal circumstances could create a smaller market of borrowers that qualify for assistance.

Allowable Borrower Fees from Lenders

As the agency collects more data, it wants to ensure that borrowers are only charged for services provided directly to them and not passed on from the lender.

OFA has also proposed more clarity on the allowable fees to borrowers that lenders can charge. The proposed rule moves to eliminate the "two master" rule that allows for third-party agents to collect a fee from both the borrower and the lender in certain circumstances. This is being addressed because the SBA has increased its focus on tracking and understanding the role of agents in the SBA loan process. As the agency collects more data, it wants to ensure that borrowers are only charged for services provided directly to them and not passed on from the lender.

Affiliation Updates

Another proposed change has been created to address affiliation among businesses. This rule has long been key in concluding whether a business should be considered "small" and qualify for SBA financing. The focus of the change is on economic dependence between entities and how this might cause an issue with affiliation. The OFA has suggested that any business that receives 85% or more of its revenue from one customer could be considered an affiliate. While there are exceptions for any new business, this could directly affect niche manufacturers and agricultural businesses (e.g. poultry and other meat type businesses) that provide a part or a resource to large businesses that would not normally qualify for the 7(a) Program on their own.

Each of these rules has seen some opposition from lenders in the market and depending on how the final rules are written and enforced, they could all reduce the number of applicants that qualify for the program. If a version of each of these rules is enacted, another year of slight volume decreases across the entire program are expected. OFA is currently reviewing industry comments on their proposed changes and are expected to push out any final changes over the coming months.

B. Servicing

Leonard Ray, Managing Director

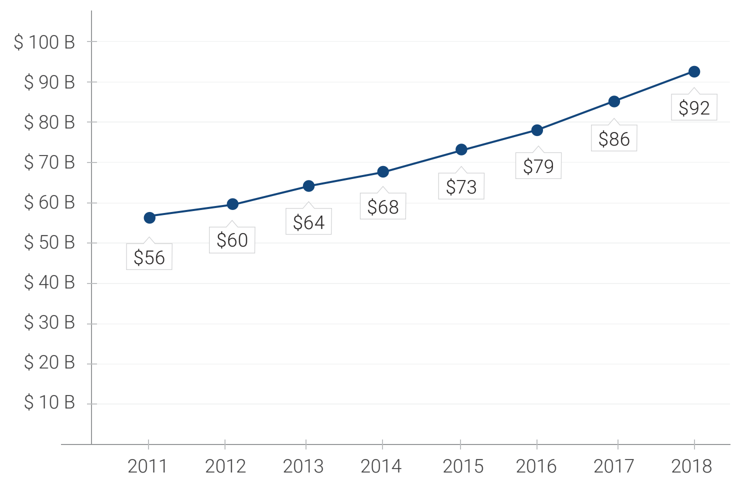
The SBA's 7(a) loan portfolio is continuing its steady growth trend along with the growth of the economy. Delinquency rates are also comfortably low — giving us a fairly confident outlook for low charge-offs in FY2019.

Servicing requirements are extensive and non-compliance with reporting can result in lengthy and complicated reconciling items with the SBA, as well as the potential for repairs and denials of guarantees. Lenders should ensure they are servicing loans well in accordance with the standards set forth by the SOP 50 57 and the lender's internal policies and procedures.

7(a) Portfolio Continues Steady Growth Trend

[14] As of FY2018, the SBA oversees a $92 billion SBA 7(a) loan portfolio. SBA estimates that small business currently owe $1 trillion in business loans, and SBA loans make up roughly 7.6% of the trillion dollars in outstanding debt. The table below shows the total amount of the 7(a) Program's unpaid principal balance by fiscal year:

SBA 7(a) Unpaid Principal Balance (In Billions)



SOURCE [15]

According to the SBA, three primary factors have contributed to the portfolio's recent outstanding balance growth:

- Continuous economic growth
- Increasing business financial stability
- Statutory changes to SBA loan programs

[14] *Office of Advocacy – p 1; Small Business Administration*

[15] *SBA Loan Program Performance – Unpaid Principal Balance by Program*

C. Intensive Servicing

Will McClain, Managing Director

Non-compliance with intensive servicing requirements — for both modifications and liquidations — can result in the potential for repairs and denials of guarantees. Intensive servicing consists of interim servicing actions with proper file documentation, workout and modification support, and execution of liquidation and litigation plans.

To mitigate risk, lenders must manage this task well and ensure that all reported events are processed properly for necessary approval and that the file is documented adequately to protect the lender in the case of liquidation. It is considered a best practice for lenders to maintain direct relationships with the SBA and an up-to-date understanding of current SBA requirements.

Two intensive servicing themes to watch in 2019:

- Continued increase in purchase rates
- Charge-off rates continue to decline

Purchase Rates Continue to Increase

Purchase rates – the total dollar amount of principal and interest purchased by the SBA on a guaranteed default loan – has increased for the second year in a row up from FY2017 by more than 17%.

Purchase rates – the total dollar amount of principal and interest purchased by the SBA on a guaranteed default loan – has increased for the second year in a row up from FY2017 by more than 17%. This is likely due to rising interest rates taking their toll on borrowers who have experienced 2.25% in total rate increases over the last three years. That change in rate can create as much as a $60,000 change in annual payment. With few other better options in the market for under collateralized loans, we expect to see this trend continue.

Fiscal Year	Purchased Amount	% Change
2010	$2,549,225,625	13.7%
2011	$1,672,383,598	-34.4%
2012	$1,282,071,858	-23.3%
2013	$1,063,673,949	-17.0%
2014	$828,434,059	-22.1%
2015	$709,397,228	-14.4%
2016	$588,237,859	-17.1%
2017	$655,692,233	11.5%
2018	$770,519,633	17.5%

Fiscal Year	Purchase Rate % UPB	% Change
2010	5.58%	10.5%
2011	3.29%	-41.0%
2012	2.37%	-28.0%
2013	1.85%	-21.9%
2014	1.33%	-28.1%
2015	1.03%	-22.6%
2016	0.77%	-25.2%
2017	0.79%	2.6%
2018	0.86%	8.9%

SOURCE [16]

[16] *SBA Loan Program Performance – Purchase Amounts & Rates by Program*

Charge-Off Rates Continue to Decline

While the SBA has seen an increase in purchase rates, charge-off rates have continued to decline. Charge-Off rates are the actual dollars charged off on all loans for a 12-month period relative to the outstanding principal balance of all loans at the end of the fiscal year. Because charge-off numbers are registered after liquidation of the assets occurs, it can be a trailing indicator for how the market has performed

Fiscal Year	Charge-Off Amount	% Change
2010	$1,348,673,024	90.8%
2011	$1,013,180,788	-24.9%
2012	$673,545,176	-33.5%
2013	$486,932,022	-27.7%
2014	$806,928,976	65.7%
2015	$1,475,539,131	82.9%
2016	$1,431,055,021	-3.0%
2017	$689,451,055	-51.8%
2018	$473,207,996	-31.4%

Fiscal Year	Charge Off Rate % UPB	% Change
2010	2.65%	81.5%
2011	1.80%	-32.1%
2012	1.12%	-37.8%
2013	0.76%	-31.1%
2014	1.18%	55.3%
2015	2.02%	71.2%
2016	1.82%	-9.9%
2017	0.80%	-56.0%
2018	0.51%	-36.3%

SOURCE [17]

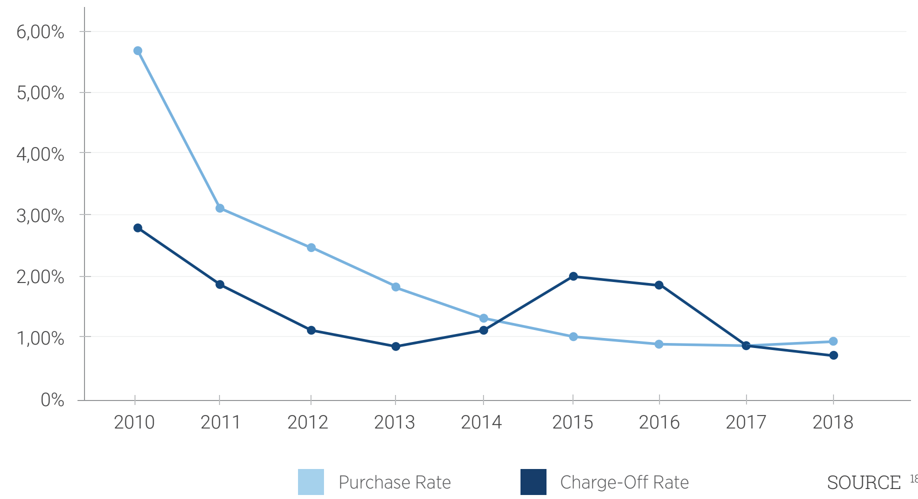
As shown in the table above, charge-off dollars and rates have fluctuated greatly year-over-year. The key is to understand that while the rate generally follows economic trends, it will lag and not entirely follow the same trends as the delinquency and purchase rates.

The rise of 7(a) charge-offs starting in FY2013 is attributable to the SBA wrapping up loans that went into liquidation during the recession. Loans not sold on the secondary market are tracked as charge-off loans only after all efforts to recover a delinquent balance and collateral have been exhausted. Beginning in FY 2016, these efforts were starting to wind down.

[17] *SBA Loan Program Performance – Charge-Off Amounts & Rates by Program*

Loans not sold on the secondary market are tracked as charge-off loans only after all efforts to recover a delinquent balance and collateral have been exhausted. Beginning in FY 2016, these efforts were starting to wind down.

Purchase Rates v. Charge-Off Rates - % of UPB



SOURCE [18]

As illustrated above, the two rates do not perfectly align. While both seem to speak to a similar concept, the charge-off rate fluctuates a lot more than the purchase rate for loans that have actually gone bad for a number of different reasons. Because the charge-off amount is determined after liquidation and some liquidations can take years to complete, we expect to see the rate level out and begin to increase over the next 24 months.

[18] *Agency Financial Report FY2018 – p 28; Small Business Administration*

D. Regulatory Support & Compliance

Jeff Nogle, Director of Risk Management

Program and regulatory compliance remain critical to a successful and sustainable SBA lending strategy. As SBA dollar volume neared a record high, following five consecutive years of growth, Congress continues to emphasize the need for proper lender oversight and OCRM continues to make progress on similar directives. As OCRM continues to improve the identification of inherent risks to the program and within SBA's loan portfolio, it's critical for all market participants to proactively analyze and control risk for their own success.

OIG Notes Improvements in Lender Oversight - Room for Progress Remains

Because OCRM manages a roughly $132 billion loan portfolio (including 504) and SBA maintains 7(a) appropriations of more than $27 billion per year, Congress continues to keep a close eye on the SBA. In previous investigations, the Office of the Inspector General (OIG) noted deficiencies in the SBA's execution of identifying lender weaknesses, developing a portfolio risk management program and identifying and tracking third-party agents. [18] In its most recent report dated October 11, 2018 (Report #19-01), OIG noted significant improvement in lender oversight and the development of OCRM's portfolio risk management program. OCRM's Lender Portal, SBPS Monitoring and PARRiS Scoring have been a large part of that development, proving to be a valuable tool for the SBA to identify lender and portfolio strengths and weaknesses. In 2018, OCRM made several enhancements to the portal, including adding higher risk flags associated with start-ups, small loans and concentration in hotels.

In 2019, lenders should expect the SBA to provide more guidance on loan agents and agent fees. Additionally, lenders should anticipate offsite and/or onsite OCRM audits as their SBA portfolio continues to grow and season.

However, OIG noted that the SBA needs to continue to make progress on the portfolio risk management program and the identification and tracking of third-party agents. Third-party agents and borrower paid fees continue to gain momentum as a hot-topic within the industry. In 2019, lenders should expect the SBA to provide more guidance on loan agents and agent fees. Additionally, lenders should anticipate offsite and/or onsite OCRM audits as their SBA portfolio continues to grow and season.

Capabilities of the Lender Portal and SBPS Monitoring

Effective risk management practices for lenders include utilizing the Lender Portal and SBPS Monitoring tools that OCRM offers for continuous lender self-evaluation.

[19] *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in FY2019*

PARRiS (P = Portfolio Performance; A = Asset Management; R = Regulatory Compliance; Ri = Risk Management; and S = Special Items) scores allow a lender to understand how OCRM views their portfolio as a whole. This score is a combined analysis of various risk factors and ultimately generates an aggregate score, allowing lenders to evaluate their portfolio on an overall basis. Loan level detail in comparison with lenders' internal risk rating allows for an analytical and proactive approach to effectively manage risk.

The Small Business Predictive Score (SBPS) is a credit score used by SBA to predict the likelihood of default purchases and ranks individual loans within a range between 0 – 300. The likelihood of delinquency, portfolio risk and lender performance across the lifecycle of each loan can be useful to lenders, especially when used in conjunction with internal risk rating and portfolio management. As the scores increase for a given set of loans, the probability of purchase for those loans decreases. Loans with scores in a higher range can be considered to have less risk of purchase than those with scores in a lower range. This scoring is used by the SBA as an indicative measure of the current credit quality of a lender's SBA loan portfolio.

Regulatory Conclusion

Lenders must provide comprehensive and proactive support for all types of examinations, starting with OCRM Risk-Based Reviews and extending to FFIEC Safety and Soundness examinations, internal audits and file reviews. Lenders are strongly recommended to participate in customized training, both internal and external, in order to stay up-to-date on the changing regulatory environment. In addition, lenders should consider joining trade associations such as the National Association of Government Guaranteed Lenders (NAGGL) and participating in its national and regional trainings.

VIII. Conclusion

As overall volume stabilizes and fewer lenders participate in the program, competition among lenders seeking eligible borrowers will likely continue to increase, forcing more lenders to find a niche to effectively serve small-business customers. The competitiveness of the marketplace, dominated by the top 50 lenders providing more than half the loans, requires that remaining participants increase their technological sophistication and assess potential opportunities in target markets to compete more effectively. In addition, increased regulatory lender oversight is expected to grow and 2019 will be a year to focus on program and process compliance. Lastly, slow, but positive movement,for government guaranteed secondary market premiums will continue to shape lender's 2019 strategies as they compete for strong opportunities. We encourage all SBA lenders to consider the themes outlined in this article across all aspects of commercial lending. Whether lenders use the framework detailed in this outlook or design their own, lenders can expand the likelihood of success through increased volume, credit quality and regulatory compliance by focusing on growth through strategy and technology with a foundation in risk management – all of which are critical to SBA lending success in 2019 and beyond.

About Windsor Advantage, LLC

Windsor Advantage provides banks, credit unions and CDFIs with a comprehensive outsourced SBA 7(a) and USDA lending platform.

Since 2010, Windsor has processed more than $2.3 billion in government guaranteed loans and currently services a portfolio in excess of $1.3 billion (as of February 28, 2019) for more than 85 lenders nationwide. With over 150 years of collective government guaranteed lending experience, cutting-edge technology and rigid controls, Windsor Advantage is uniquely qualified to assist clients with implementing a thoughtful and profitable lending initiative.

Windsor Advantage has a team of 27 professionals with offices in Chicago, Illinois; Indianapolis, Indiana; and Charleston, South Carolina. For more information, contact (312) 248-8530 or visit www.WindsorAdvantage.com.