SBA Information Notice

TO:	All SBA Employees and Certified Development Companies (CDCs)	**CONTROL NO.:**	5000-1398
SUBJECT:	Updated SMART Methodology for Oversight of CDCs	**EFFECTIVE:**	November 9, 2016

Introduction

SBA's Office of Credit Risk Management (OCRM) has updated its composite risk measurement methodology and scoring guide, "SMART," which SBA developed for the oversight of Certified Development Companies (CDCs), as first introduced in Policy Notice 5000-1348 dated August 5, 2015 (Policy Notice). This Information Notice provides notification that selected quantitative factors being used in the SMART components have been revised and the risk tolerance thresholds have been updated.

SMART Methodology

As further described in the Policy Notice, SMART is an acronym for the specific risk areas or components that SBA reviews for CDCs. The components and their measurement objectives are as follows:

Component	Measurement Objective
"S" – Solvency and Financial Condition	CDC's financial ability to operate and portfolio performance.
"M" – Management and Board Governance	Organizational structure, policies, and internal controls.
"A" – Asset Quality and Servicing	Quality of the CDC's 504 loan origination, closing, servicing and liquidation practices.
"R" – Regulatory Compliance	CDC's compliance with SBA Loan Program Requirements.
"T" – Technical Issues and Mission	Additional key metrics or items that are not included in the other components but may pose risk to SBA or present program integrity concerns.

Each SMART component includes qualitative and quantitative factors. All quantitative factors are benchmarked and scored against risk tolerance thresholds established by SBA, producing a SMART Score. The qualitative factors include, but are not limited to, consideration of: compliance with SBA Loan Program Requirements (as defined under 13 CFR § 120.10), changes in CDC's loan policies, management and staff capabilities, and any other aspect of the CDC's 504 program. Review of the qualitative and quantitative factors allows SBA to better identify a CDC's specific risk areas, assess the level of risk a CDC poses to SBA, and make recommendations for corrective action as needed.

With this Information Notice, SBA is announcing that two SMART component quantitative factors have been revised, and is also providing notice that component risk tolerance thresholds have been updated to incorporate current performance of SBA's 504 loan portfolio. The SMART methodology, including but not limited to the qualitative and quantitative factors, may be revised from time to time.

Updated SMART Methodology With Component Factors

The quantitative[1] and qualitative SMART factors effective with the publication of this Information Notice include, but are not limited to, the following as set forth below. The changed factors are highlighted in **bold and underlined**.

"S" – Solvency and Financial Condition

Quantitative Factors	Qualitative Factors
• 5-year cumulative net yield	• Reserves for future operations
• 12-month default rate	• Liquidity risk management
• 5-year default rate	• Balance sheet leverage

"M" – Management and Board Governance

Quantitative Factors	Qualitative Factors
• **Forecasted purchase rate (FPR)** (replaces Lender Purchase Rating (LPR))	• Board-approved internal control policies, including independent loan review and loan classification system
• High risk origination rate	• Business strategy and planning
• Loans in purchase status over 3 years rate	• Audit and review programs
	• IT operations
	• Management of risk concentrations

A"- Asset Quality and Servicing

Quantitative Factors	Qualitative Factors
• Stressed loan rate (Past Due + Delinquent + Deferred Loans)	• Credit administration
• **5-year charge-off rate** (replaces Recovery rate (over last 5 years))	• Servicing and liquidation management
• Early problem loan rate	• Potential fraud, negligence, or misrepresentation issues on individual 504 loans

[1] SBA provides definitions for each of the quantitative factors and the updated risk tolerance thresholds in the Lender Portal.

“R” – Regulatory Compliance

Quantitative Factors	Qualitative Factors
• Minimum level of 504 Loan activity	• Timely and complete submission of CDC Annual Report (and PCLP Loan Loss Reserve Report, if required)
	• Liability insurance minimums

“T”- Technical Issues and Mission

Quantitative Factors	Qualitative Factors
• Average SBPS score (weighted)	• CDC support of “other economic development initiatives”
• Top industry concentration rate	• Job creation and retention documentation
	• Professional services contracts
	• Franchise concentration rate

The New Quantitative Factors

The **Forecasted purchase rate (FPR)** projects the percent of a CDC’s debenture portfolio that will be purchased over the next 12 months. It is calculated from the dollar-weighted loan-level predicted purchase rate for each 504 loan. SBA is replacing the LPR (a/k/a Lender Risk Rating (LRR)) in SMART given that SBA already separately tracks the LPR/LRR and because the FPR as a rate can be used to provide further information (e.g., it can be used to project the dollar amount of a CDC’s debenture purchases simply by multiplying the rate by the CDC’s Gross Dollars Outstanding).

The **5-year charge-off rate** measures the total dollars charged-off during the past 5 years as a percentage of the total Gross Dollars Outstanding plus total dollars charged-off during the past 5 years. SBA is replacing the Recovery rate metric in SMART with the more comprehensive charge-off rate that effectively provides a CDC’s portfolio loss rate. This measure is distinguished from the 5-year cumulative net yield in that the net yield takes into account the cash flow associated with loan fees.

Except as revised by this Information Notice, Policy Notice 5000-1348 (dated August 5, 2015) remains unchanged and continues to be in effect. A separate notice covering the updated PARRiS methodology for Federally-regulated 7(a) Lenders is being issued.

Questions
Questions on this updated SMART methodology may be directed to Adrienne Grierson, Deputy Director, Office of Credit Risk Management at Lender.Oversight@sba.gov.

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Director
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