



SBA Procedural Notice

TO: All Employees

LIMIT NO.: 5000-1086

SUBJECT: Initiative to Facilitate the Sale of
SBA 7(a) Loans on the Secondary
Market

EFFECTIVE: 12-17-2008

Introduction

Due to the recent uncertainty and disruption in American and International capital markets, which has substantially affected the secondary market for SBA backed securities, SBA is continuing to coordinate and collaborate with the President's Working Group on Financial Markets to stabilize and restore confidence in those markets. This notice describes SBA policy changes recently implemented by regulation, which are designed to better facilitate the formation and pricing of pools of SBA guaranteed loans for sale on the secondary market. These changes will significantly increase the potential liquidity of SBA lenders and thereby expand their lending to the small business community during this critical time.

Background

The Small Business Secondary Market Improvements Act of 1984 authorized SBA to facilitate the pooling of the guaranteed portion of SBA loans made under Section 7(a) of the Small Business Act in order to foster and enhance their marketability on the Secondary Market. The availability of an active secondary market for SBA loans provides SBA lenders with an efficient process through which to sell their SBA backed loans, which significantly increases their liquidity and enables them to make additional SBA loans. (Additional information on pooling SBA loans may be found in SBA's Secondary Market Program Guide, available at http://www.colsonservices.com/main/f_n_r_main.shtml.)

The interest rate on SBA guaranteed loans is negotiated between the lender and the borrower, so there is wide variability in the interest rates found in SBA backed securities. In addition, the amount of any applicable fee (servicing fee and premium protection fee) that is to be retained by the lender is negotiated between the lender and the first purchaser of the note (usually a broker or securities dealer), which adds additional variability to the pricing of SBA backed securities. This variability greatly complicates the pooling of SBA loans for sale on the secondary market, because loan pools generally have similar interest or coupon rates. It also makes the pooling and sale of SBA loans less attractive, because it contrasts with the consistency found in other types of securities sold on the secondary market. As a result, SBA published changes to its regulations on November 13, 2008, to further facilitate the sale of SBA loans on the secondary market. Effective with this notice, the Agency is initiating the Weighted Average Coupon (WAC) Pool concept by adding the enclosed Chapter 8, Weighted Average Coupon Pools, to the SBA's Secondary Market Program Guide.

The SBA will continue to adjust the maturity ratio (percentage of the shortest term loan in a pool of the longest term loan) to maintain a zero subsidy rate for pools within any given cohort

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SBA Form 1353.2 (2-93) MS Word Edition; previous editions obsolete
Must be accompanied by SBA Form 58

(fiscal) year accounted for under the Federal Credit Reform Act (FCRA). The SBA guaranty for all of its loans programs, including those sold in the secondary market, carry with them the full faith and credit of the United States Government. Programs accounted for under the FCRA are provided permanent indefinite authority for any future re-estimated costs and, should the need arise; also have authority to borrow from the Treasury.

Summary of Weighted Average Coupon Pool Concept

WAC pools will use the same basic structure as standard SBA pools, except for the calculation of the coupon rate on the pool. Instead of a pool interest rate that SBA had formerly required be set at the lowest net coupon rate of any loan in the pool, under WAC Pools the pool interest rate will be set at the weighted average net interest rate of all loans in the pool. However, all loans in a WAC pool must have a note rate that is within a 200 basis point range. In addition, the net coupon rate of the loans in any given pool must have a maximum differential of 75 basis points between the lowest and highest net coupon rate.

Unlike standard SBA pools, WAC pools contain loans that have varying net coupon rates. For example, if a pool contains twenty loans each with a principal balance of \$100,000, and ten of the loans have a net rate to the investor of prime plus 1 percent and ten have a net rate to the investor of Prime plus .5 percent, the pool would have an initial weighted average coupon rate of Prime plus .75 percent, because each loan would have a weighted rate of 5 percent or 1/20 of the pool. (WAC is calculated by multiplying the balance of each loan times the net rate to the investor on each loan, summing up the results, and dividing by the aggregate dollar value of the pool's underlying loan balances.) The WAC on the pool certificate will reset monthly based on the balance on the pool's underlying loans, which will have been affected by principal repayments, prepayments, and/or defaults in the underlying loans in the pool.

While SBA lenders will benefit from the Agency's WAC Pool initiative through increased demand for their SBA 7(a) guaranteed loans, the assembly, sale, etc., of WAC Pools will generally fall under the purview of brokers or pool assemblers. Pool assemblers or brokers or interested SBA lenders will find additional information, including the complete SBA Secondary Market Program Guide, available from SBA's fiscal and transfer agent, Colson Services, at http://www.colsonservices.com/main/f_n_r_main.shtml.

Also available will be the revised SBA Form 1454, which is used by brokers and pool assemblers to assemble and transmit SBA loan pools, including the new WAC pools at http://www.sba.gov/idc/groups/public/documents/sba_homepage/tools_sbf_finasst1454.pdf

For questions concerning this notice please contact John Wade at (202)205-3674 or john.wade@sba.gov or Jihoon Kim at (202) 205-6024 or jihoon.kim@sba.gov.

Grady B. Hedgspeth
Director
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Secondary Market Program Guide

Chapter 8

Weighted Average Coupon Pools

The Small Business Secondary Market Improvements Act of 1984 (P.L. 98-352) authorized SBA to develop a program for the Pooling of the SBA guaranteed portion of loans made under Section 7(a) of the Small Business Act (Guaranteed Loan(s)). Under such authority, the Small Business Administration permits the creation of Weighted Average Coupon (WAC) Pools. These are pools where the coupon rate on the pool will fluctuate based on the weighted average interest rate on all the loans in the pool.

The risks associated with the changes in the coupon rate and the resulting change in the value of the pool are borne by the investor.

1. Description

Unlike standard SBA pools, WAC pools contain loans that have varying net coupon rates. For example, assume a pool contains twenty loans, each with a principal balance of \$100,000. Ten of the loans have a net rate to the investor of prime plus 1% and ten have a net rate to the investor of prime plus .5%. In this example, the pool would have an initial WAC of prime plus .75%, with each loan having a weighted rate of 5%. WAC is calculated by multiplying the balance of each loan times the net rate to the investor on each loan, summing up the results and dividing by the aggregate dollar value of the pool's underlying loans' balances. If the ten loans with a prime plus 1% net rate to the investor all prepaid or defaulted, the WAC would become prime plus .5% and, assuming the same market conditions, the security would have less value.

2. Purpose

Because the Note interest rate on SBA guaranteed loans is negotiated between the lender and the borrower, the guaranteed loan program does not have the consistency of interest rates that is found with other types of loans. In addition, the amount of the retained fee (servicing fee and premium protection fee) is negotiated between the lender and the first purchaser (usually a securities dealer). This can lead to SBA loan securities having a variety of different net coupon rates. The use of WAC pools helps facilitate the pooling of loans with different interest rates.

The other method of handling this situation is to strip a portion of the interest coupon on the individual loan security. This interest only strip, known in the SBA market as an originator fee, is sold to an investor in a separate transaction. (Originator fees are not applicable in WAC pools)

and as such, stripping off the portion of the interest coupon on the individual loan security will not be permitted.)

3. Structure

WAC pools will use the same basic structure as standard SBA pools with the exception of calculating the coupon rate on the pool. All loans in a WAC pool must have a note rate that is within a 200 basis point range (the same as the requirement for the standard pool). Instead of a pool interest rate that is set at the lowest net coupon rate of any loan in the pool, the pool interest rate will be the weighted average net interest rate of all loans in the pool. The pool certificate interest rate will be calculated using the method described above. The WAC on the pool certificate will reset monthly based on the balance on the pool's underlying loans, which are affected by principal repayments, prepayments and defaults of loans in the pool.

4. Guaranty

The WAC pool will have the same timely payment guaranty of interest and principal installments and any prepayments or other recoveries on the underlying loans as described in the Agency's guaranty that appears on the standard SBA pool certificate.

5. Eligible Loans

Pools will consist solely of loans guaranteed under Section 7(a) of the Small Business Act and Section 502 of the Small Business Investment Act. Loans must be fully disbursed prior to sale into the secondary market and in a current status as of the issue date of the pool. A loan is considered in current status if the interest paid-to-date is no more than 60 days prior to the issue date of the pool. For example, all loans for inclusion in a WAC pool with a November 1 issue date must have a paid-to-date of no earlier than September 2. The lenders' records will be used for loans where the guaranteed portion has not been sold in the secondary market. The books of the FTA will be used for loans where the guaranteed portion has already been sold.

6. Pool Assemblers

Any entity that is permitted to form standard SBA pools will be permitted to form WAC pools.

7. Pool Application Form

Pool assemblers must use Form 1454 to form a WAC pool. This special form is designed to accommodate the various net coupon rates on the loans in the pools and to require that the pool assembler calculate the weighted average coupon. The FTA will check the calculation and any errors must be corrected before the pool can be created.

8. WAC Pool Characteristics

- (a) Minimum number of guaranteed portions in a pool is 10.

- (b) Minimum aggregate principal balance of guaranteed portions outstanding at the time of certificate issuance is \$1,000,000.
- (c) Minimum face amount of any WAC pool certificate is \$25,000.
- (d) All certificates must be in multiples of \$5,000 with the exception of one certificate per pool.
- (e) The maximum allowable difference between the highest note rate and the lowest note rate of loans in a WAC pool is 200 basis points.
- (f) SBA will permit a maximum differential of 75 basis points between the lowest net coupon rate and the highest net coupon rate for guaranteed portions in an individual WAC pool. This amount will give pool assemblers the flexibility needed to handle loans with slight differences in the net interest rate, yet should prevent large swings in the value of the security due to the prepayment or default of one of the loans in the pool. Interest only strips are not allowed on the WAC pools.
- (g) The shortest remaining term to maturity of any loan in a pool must be at least the published percent (i.e. 76 % for fiscal year 2009) of the longest remaining term to maturity of any loan in a pool. That percent is adjusted to maintain the program at a zero subsidy rate and will be published annually. Term to maturity shall be measured in months from the pool issue date. Fractions produced as a result of multiplying the longest term by the applicable percentage and shall be rounded up to the nearest whole month.
- (h) No individual guaranteed portion principal balance may constitute more than 10% of a pool.
- (i) Guaranteed portions in a pool must either be all fixed rate or all variable rate. When the guaranteed portions have a variable interest rate, they must float on the same basis (i.e. Prime base rate/LIBOR Base Rate/SBA Optional Peg Rate and adjustment period).
- (j) Mixed rate loans (where the unguaranteed portion retained by the lender has a variable rate and the guaranteed portion placed in the pool has a fixed rate) must be included in a fixed rate pool.
- (k) Pools are closed end. This means that loans may not be added to a pool once the pool has been issued and loans that prepay or default may not be replaced.
- (l) Fixed rate pools will be issued at any time during the month. Fixed rate pools will have an issue date of the 15th of the month.
- (m) Variable rate WAC pools will be issued at any time during the month. Variable rate WAC pools will have an issue date of the 1st of the month.

(n) All guaranteed portions in the pool must be valued at par.

Along with meeting the above-described pool criteria, the special characteristics of loans in a pool must be similar. For example, all loans in a variable rate pool must have the same base rate and fluctuate on the same basis. If one loan in the pool has an interest rate cap, the pool will have a cap equal to the lowest net cap rate.

9. WAC Calculation

WAC calculation calls for weighting the net interest rate of each loan by the quotient of the principal outstanding in that loan over the total principal outstanding for the pool. This weighting is performed on the net interest rate of each loan and all weighted coupon results are summed. The result is the weighted average coupon or WAC. Algebraically, this is expressed as follows:

$$\text{WAC} = [\text{NI}_1 * (\text{P}_1/\text{P}_p)] + [\text{NI}_2 * (\text{P}_2/\text{P}_p)] \dots [\text{NI}_i * (\text{P}_i/\text{P}_p)]$$

Where: NI_{1-i} = Net interest rate on loans 1 through i
 P_{1-i} = current principal outstanding on loans 1 though i
 P_p = the sum of principal outstanding on loans 1 through i

Net rate and the WAC calculation would be calculated with 3 digits out from decimal with 4th digit being round up when it is 5 or higher and round down when it is 4 and lower. With a WAC pool there is no longer a single rate for the pool. The pool payment is a result of the payable derived from each loan separately. The pool rate, defined as interest payable over aggregate principal outstanding, will change as the relative weight of each loan in the pool changes. The wider the range in net interest rates, the more volatility in the WAC that may be experienced by an investor in the pool.

Simple WAC Calculation Sample:

Guaranty Balance	Net Spread	WAC Calculation
\$89,250.00	7.865%	0.4854%
\$136,695.01	8.355%	0.7897%
\$119,621.93	8.105%	0.6704%
\$203,183.29	8.355%	1.1738%
\$102,179.83	7.905%	0.5585%
\$86,852.31	8.455%	0.5078%
\$124,843.75	8.495%	0.7333%
\$167,311.97	7.765%	0.8983%
\$81,748.82	8.265%	0.4672%
\$90,815.22	8.065%	0.5064%
\$243,750.00	8.265%	1.3930%
Total Guaranty Balance		
\$1,446,252.13	WAC:	8.184%

10. Payments to Investors

Payments to investors will be monthly based on a 30/360 amortization schedule. This is the same amortization method and payment schedule used on standard SBA pools.

11. Payment Structure

The following is a description of how Pool payments will be made to Registered Holders of WAC pool certificates:

(a) All payments to a Registered Holder will consist of principal and interest. This includes the first payment and all subsequent regular payments.

(b) When a Guaranteed Loan in a Pool is prepaid in full, the amount that is passed through to Registered Holders will be the principal and interest that was received at the time of prepayment plus any amortization excess associated with that Guaranteed Loan that has accumulated in the Master Reserve Fund (MRF). Thus, if a seven year Guaranteed Loan in a 10-year Pool is prepaid in year three, the prepayment will be passed through to Registered Holders along with the amortization excess on that Guaranteed Loan that had accumulated in the MRF. The prepayment funds will be paid to the Registered Holder on the next FTA Payment Date for Pool Payments.

(d) If a borrower makes a partial prepayment, the principal and interest prepaid will be passed through to Registered Holders with the next scheduled payment. Any amortization excess will remain in the Pool to term or expiration.

(e) Unscheduled principal payments will be distributed to all Pool Certificate holders on a pro rata basis according to their percentage of the total Pool principal. Distributions of unscheduled principal will be made on the next scheduled payment date after receipt.

EXAMPLE: Unscheduled principal payments received between October 1 and October 31 are reflected in the October 31 ending Pool principal balance and reflected in the November 1 factor table. The payment will be made to holders of record as of October 31 on December 25.

12. Certificate

The WAC pool certificate will specify an initial principal amount and a maturity date. The WAC pool certificate will not have a certificate interest rate on its face. It will have the current weighted average coupon rate of the loans in the pool. All certificates will be issued in registered form as an SBA full faith and credit instrument. All transfers of ownership of the certificate must be registered at the FTA.

13. Distribution on Payment Date

The FTA will make payments to holders of record as of the last business day of the month, as shown on the books of the FTA. Checks will be mailed by the FTA on the 25th day of each month or the next succeeding business day if the 25th is not a business day. Payment by wire is available on the last business day of the month for an extra charge of \$24.35 per wire transfer. The Depository Trust and Clearing Corporation (DTCC) payments are wired on the third business days subsequent to the check issue date.

14. Maturity

The last scheduled payment date of a pool is the payment date in the month after the maturity date of the individual loan having the longest remaining term in the pool.

15. Transferability

Each certificate shall be transferable, but only on the books and records of SBA or the FTA. The share of the proceeds collected on account of the pool may not be payable to more than one registered holder with respect to any certificate.

16. Period of Interest Guaranteed

Interest on prepaid or defaulted loans accrues and is guaranteed by SBA only through the date immediately preceding the date of FTA's receipt of prepayment or repurchase payment by lender or payment of the guaranty by SBA.

17. Required disclosure

Prior to any sale, the Pool Assembler and any other seller of a WAC Pool Certificate must disclose to the purchaser information on the terms, conditions and yield of the Pool Certificate. The yield information must be based on a Constant Prepayment Rate (CPR) that is reasonable and based on program experience. This information must be included on the Form of Detached Assignment for U.S. Small Business Administration Loan Pool or Guaranteed Interest Certificate (SBA Form 1088). A copy of this SBA Form 1088 will be provided to the purchaser so that it can verify that the CPR reported to SBA matches the CPR that the seller provided to the purchaser.

In addition to the SBA Form 1088 information, the loan level information on each Pool will be made available via the online Factor Report issued by the FTA. The loan level information includes outstanding balance, net interest rate and maturity of all loans within a Pool.

18. CUSIP Number

Each Pool will have a CUSIP Number. The CUSIP (Committee on Uniform Securities Identification Procedures) numbering system is used by the securities industry as a standard means of identifying securities. The CUSIP number is a series of numbers and letters that is unique to a particular issue. The CUSIP numbers for Pools are assigned by the CUSIP division

of Standard and Poor's Corporation, and are managed by the FTA. The cost of the CUSIP number is included in the Pool application fee.