



SMALL BUSINESS ADMINISTRATION

[Docket No. SBA-2018-0008]

Community Advantage Pilot Program

AGENCY: U.S. Small Business Administration.

ACTION: Notice of extension of and changes to Community Advantage Pilot Program; and request for comments.

SUMMARY: The Community Advantage (“CA”) Pilot Program is a pilot program to increase SBA-guaranteed loans to small businesses in underserved areas. The Small Business Administration (“SBA”) continues to refine and improve the design of the Community Advantage Pilot Program. To support SBA’s commitment to expanding access to capital for small businesses and entrepreneurs in underserved markets, SBA is issuing this Notice to extend the term of the CA Pilot Program, to mitigate risks of the program by placing a moratorium on accepting new CA Lender applications, to limit fees that can be collected from an applicant for a CA loan, and to revise other program requirements.

DATES: The moratorium on accepting applications from lenders for participation in the CA Pilot Program and all other changes identified in this Notice will be effective on October 1, 2018. The CA Pilot Program will remain in effect until September 30, 2022.

Comment Date: Comments must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by SBA docket number SBA-2018-0008, by any of the following methods:

- Federal eRulemaking Portal: <https://www.regulations.gov/>. Follow the instructions for submitting comments.
- Mail: Daniel Upham, Acting Director, Office of Economic Opportunity, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416 or Dianna Seaborn, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416.
- Hand Delivery/Courier: Daniel Upham, Acting Director, Office of Economic Opportunity, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416; or, Dianna Seaborn, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416.

SBA will post all comments on https://www.regulations.gov. If you wish to submit confidential business information (CBI) as defined in the User Notice at https://www.regulations.gov, please submit the information to Daniel Upham, Acting Director, Office of Economic Opportunity, U.S. Small Business Administration, 409 Third Street, SW, Washington, DC 20416, or Dianna Seaborn, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416, or send an email to communityadvantage@sba.gov. Highlight the information that you consider to be CBI and explain why you believe SBA should hold this information as confidential. SBA will review the information and make the final determination as to whether it will publish the information.

FOR FURTHER INFORMATION CONTACT: Daniel Upham, Acting Director, Office of Economic Opportunity, U.S. Small Business Administration, 409 Third Street SW,

Washington, DC 20416, (202) 205-7001, daniel.upham@sba.gov; or, Dianna Seaborn, Director, Office of Financial Assistance, U.S. Small Business Administration, 409 Third Street SW, Washington, DC 20416, (202) 205-3645, dianna.seaborn@sba.gov.

SUPPLEMENTARY INFORMATION:

1. Background

On February 18, 2011, SBA issued a notice and request for comments introducing the CA Pilot Program (76 FR 9626). The CA Pilot Program was introduced to increase the number of SBA-guaranteed 7(a) loans made to small businesses in underserved markets. The February 18, 2011 notice provided an overview of the CA Pilot Program requirements and, pursuant to the authority provided to SBA under 13 CFR 120.3 to suspend, modify or waive certain regulations in establishing and testing pilot loan initiatives, SBA modified or waived as appropriate certain regulations which otherwise apply to 7(a) loans for the CA Pilot Program.

Subsequent notices have made changes to the CA Pilot Program to improve the program experience for participants, improve their ability to deliver capital to underserved markets, and appropriately manage risk to the Agency. These notices were issued on the following dates: September 12, 2011 (76 FR 56262), February 8, 2012 (77 FR 6619), November 9, 2012 (77 FR 67433), and December 28, 2015 (80 FR 80872). In the December 28, 2015 notice, SBA stated that it would evaluate the CA Pilot Program to refine the program and to determine whether it should be made permanent, with evaluation criteria including, but not limited to, whether the pilot is achieving its objective(s), impact on job creation and retention, impact on business creation and/or business expansion, whether the costs (including losses) of the pilot are within an

acceptable range, and portfolio performance as it relates to other 7(a) programs. SBA recently conducted an analysis to compare the performance of CA loans to other relevant groups of 7(a) loans and to the entire 7(a) portfolio, and found that CA loans exhibit more risk than other 7(a) loans. As discussed further below, the analysis found that the CA loan portfolio had a higher early problem loan rate, higher early default rate, and the last 12 month default rate is trending higher than other similar 7(a) loans and the overall 7(a) portfolio. In an effort to mitigate this risk and in order to ensure that SBA's Office of Credit Risk Management ("OCRM") continues to be able to properly oversee lenders participating in the CA Pilot Program, SBA is issuing this Notice to place a moratorium on the acceptance of new Community Advantage Lender Participation Applications ("CA Lender Applications") and to further revise program requirements, as described more fully below.

The CA Pilot Program is currently set to expire March 31, 2020. With this Notice, SBA is extending the pilot program until September 30, 2022. This extension will allow for additional time to evaluate the pilot, and if warranted, begin the process for it to be made permanent.

2. Comments

Although the moratorium on accepting applications for new CA Lenders and all other changes are effective October 1, 2018, comments are solicited from interested members of the public on all aspects of the CA Pilot Program. Comments must be submitted on or before the deadline for comments listed in the DATES section. SBA will consider these comments and the need for making any revisions as a result of these comments.

3. Changes to the Community Advantage Pilot Program

a. Moratorium on Acceptance of New CA Lender Applications

As a pilot loan program, the CA Pilot Program is intended to be available to a limited number of lenders to allow the Agency to test new methods for expanding access to capital for small businesses in underserved markets. The limited scope of the program allows SBA to evaluate its effectiveness without unduly increasing risk to the Agency. Since its inception in 2011, the CA Pilot Program has grown to 113 CA Lenders across 39 states, 99 of which are actively making and servicing CA loans. SBA has determined that there is a sufficient number and geographical diversity of CA Lenders to evaluate the pilot; therefore, it is unnecessary to further increase the number of lenders participating in the CA Pilot Program at this time.

In addition, while almost all 7(a) Lenders have a primary Federal financial regulator or a state financial regulator, all CA Lenders are classified as “SBA Supervised Lenders,” as defined in 13 CFR 120.10, and as a result, oversight of CA Lenders is more resource-intensive for SBA than oversight of other 7(a) Lenders.

Furthermore, a recent SBA analysis found that CA loans exhibit more risk than other 7(a) loans. (See <https://www.sba.gov/document/support--community-advantage-pilot-program-analysis>.) Specifically, SBA compared CA loans to non-CA 7(a) loans of \$250,000 or less, non-CA 7(a) loans of \$250,000 or less made to underserved businesses,¹ and to the entire 7(a) portfolio. The analysis found that the CA loan portfolio had a higher early problem loan rate,² higher early default rate,³ and the last 12

¹ For purposes of the analysis, underserved businesses included loans to minorities, veterans, or women-owned businesses, as reported by the borrowers.

² Early problem loan rate means the gross approval amount of young loans (36 months on book or less) that have had either a deferred, delinquent (60 or more days past due), liquidated, purchased, or charged off status within 18 months of disbursement, divided by the gross approval amount of young loans.

month default rate⁴ is trending higher than the other 7(a) loan groups and the overall 7(a) portfolio. The credit quality of the CA portfolio, as measured by the Small Business Risk Portfolio Solution (“SBPS”) Score,⁵ is also lower than the other 7(a) loan groups and the overall 7(a) portfolio. In addition, the credit quality of the CA Loan portfolio has declined since 2015 while the credit quality of the rest of the 7(a) portfolio has increased. Finally, the cumulative purchase rate⁶ of CA loans is consistently higher than the cumulative purchase rates in the other 7(a) loan groups and the overall 7(a) portfolio. For example, the cumulative purchase rate of CA loans for cohort 2013 is 7.9%, over three times greater than the cumulative purchase rate for cohort 2013 for the 7(a) portfolio (2.2%).

Given the increased risk of CA loans as compared to other 7(a) loans, the need for more resource-intensive oversight of CA Lenders, and the fact that the CA Pilot Program already includes a sufficient number of geographically dispersed CA Lenders, SBA has decided to place a moratorium on acceptance of new CA Lender applications. Effective October 1, 2018, SBA will no longer accept CA Lender Applications (SBA Form 2301). Completed CA Lender Applications that are received before October 1, 2018 will be fully evaluated, and a decision whether to allow the applicant to participate in the CA Pilot Program will be made based on the criteria in Appendix C of Version 4.0 of the Community Advantage Participant Guide, which is the version in effect at the time of

³ Early default rate means the gross balance at default of young loans (36 months on book or less) that experienced a default event (liquidation or purchase) within the first 18 months of disbursement, divided by the gross approval amount of young loans.

⁴ Last 12 month default rate means the default amount (gross outstanding balance at purchase or liquidation) of all loans that have defaulted over the last 12 months, divided by the average active balance over the last 12 months plus the default amounts of the last 12 months.

⁵ The SBPS score is an indication of the relative credit quality of the businesses and predicts a business’s propensity to become severely delinquent in debt in the next 12 to 24 months.

⁶ Cumulative purchase rate means all purchases from loans approved in the same fiscal year, divided by all disbursement dollars of loans approved in the same fiscal year.

receipt of such applications. Any CA Lender Applications that have been submitted to SBA but are incomplete as of October 1, 2018 will not be processed.

b. Expanded Underserved Market Definition

The original February 18, 2011 notice introducing the CA Pilot Program defined underserved markets to include: Low-to-moderate income communities (“LMI”); Empowerment Zones and Enterprise Communities; HUBZones; New businesses; Businesses eligible for Patriot Express, including Veteran-owned businesses; and Firms where more than 50% of their full time workforce is low-income or resides in LMI census tracts. In the December 28, 2015 notice, SBA revised this program definition to include designated Promise Zones as an underserved market. In the December 28, 2015 update to the Community Advantage Participant Guide, SBA again updated the definition of underserved market to remove “Businesses eligible for Patriot Express” and replace it with “Businesses eligible for SBA Veterans Advantage,” as the Patriot Express Pilot Initiative expired on December 31, 2013.

SBA is now further revising the definition of underserved markets to include Opportunity Zones and Rural Areas. An Opportunity Zone is an economically distressed community that has been nominated by the state and certified by the Secretary of the U.S. Treasury as a community in which new investments, under certain conditions, may be eligible for preferential tax treatment. More information and a list of Opportunity Zones for all states are available at <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>. A Rural Area, for purposes of the CA Pilot Program, is a county that the U.S. Census Bureau has defined as “Mostly Rural” or “Completely Rural” in its most recent decennial census report. More information on Rural Areas, including the 2010 County

Classification Lookup Table, is available at <https://www.sba.gov/about-sba/sba-initiatives/sba-rural-lending-initiative> and on the Welcome Screen for the Capital Access Financial System (“CAFS”) at https://caweb.sba.gov/cls/dsp_login.cfm. In order to accomplish this change, SBA is waiving the definition of “Rural Area” in 13 CFR 120.10, “Definitions”, for purposes of the CA Pilot Program.

c. Debt Refinancing

Currently, all debt refinancing in the CA Pilot Program must meet the requirements for refinancing set forth in the version of SOP 50 10 in effect at the time of loan approval, with two modifications. First, the CA Lender must demonstrate either (a) a 10 percent improvement in cash flow; or (b) that the CA loan exceeds the amount being refinanced by at least \$5,000 or 25 percent, whichever is greater. Second, a CA Lender seeking to refinance non-SBA guaranteed, same institution debt must include a transcript showing the due dates and when payments were received for the most recent six month period. If there are any late payments in the most recent six month period, the debt may not be refinanced with a CA loan. Late payments are defined as any payment made beyond 29 days of the due date.

SBA is modifying the requirements for refinancing non-SBA guaranteed, same institution debt to require a transcript showing the due dates and when payments were received for the most recent 12 month period, rather than six months. If there are any late payments in the most recent 12 month period, the debt may not be refinanced with a CA loan. In addition, debts on the CA Lender’s books for less than 12 months may not be refinanced with a CA loan.

d. Delegated Authority

OCRM evaluates all CA applicants for delegated authority eligibility at the time of application to become a CA Lender. Currently, if a prospective lender is not determined to be eligible for delegated authority at the time of approval as a CA Lender, it must wait until after it has participated in the CA Pilot Program for six months before it can request another determination. SBA is revising the eligibility requirements applicable to CA Lenders applying for delegated authority by extending the waiting period from six months to 12 months.

In addition, under current requirements, a CA Lender that is determined to be eligible for delegated authority may not process loans using its delegated authority until (i) it closes and makes an initial disbursement on five non-delegated CA loans, and (ii) OCRM determines, in consultation with the Loan Guaranty Processing Center (“LGPC”), that it has satisfactory knowledge of SBA Loan Program Requirements. SBA is increasing the number of CA loans that must be initially disbursed before a CA Lender may receive approval to process applications under delegated authority. Effective October 1, 2018, the number of loans is increased to seven.

e. Minimum Credit Score

SBA is increasing the minimum acceptable credit score for CA loans. As further described in the Community Advantage Participant Guide, all CA loan applications receive a credit score at the time of submission of the application for guaranty to SBA. A credit score at or above the minimum acceptable credit score satisfies the need to consider several required underwriting criteria, including part of the analysis to determine reasonable assurance of repayment from cash flow. If a CA Lender believes there are mitigating issues to justify a loan, despite an unacceptable credit score, the Lender may

contact the LGPC with a full credit write-up for consideration.⁷ Applications with credit scores below the minimum may not be processed under a CA Lender's delegated authority.

SBA recently compared default rates⁸ of CA loans with credit scores ranging from 120 (the current minimum) to 139, and CA loans with credit scores of 140 or greater. The analysis showed that CA loans with credit scores of less than 140 had much higher default rates, sometimes as much as three times higher than CA loans with credit scores greater than or equal to 140. Accordingly, SBA is increasing the minimum acceptable credit score for the CA Pilot Program from 120 to 140.

f. Loan Loss Reserve Requirements

CA Lenders are required to create a Loan Loss Reserve Account ("LLRA") to cover potential losses arising from defaulted loans. The reserve fund is to cover both losses from the unguaranteed portion of defaulted loans as well as possible repairs and denials associated with SBA's guaranty on CA loans sold into SBA's secondary market. In the November 9, 2012 notice, SBA reduced the LLRA requirement from 15 percent of the outstanding amount of the unguaranteed portion of a CA Lender's CA loan portfolio to five percent. In that notice, SBA also established an additional reserve requirement for CA Lenders with secondary market authority. The additional reserve requirement was set at three percent of the outstanding amount of the guaranteed portion of each CA loan sold in the secondary market.

⁷ See Community Advantage Participant Guide for further details. The requirements for a full credit write-up are set forth in SOP 50 10.

⁸ The analysis looked at last 12 month default rate, which means the default amount (gross outstanding balance at purchase or liquidation) of all loans that have defaulted over the last 12 months, divided by the average active balance over the last 12 months plus the default amounts of the last 12 months.

Given the increased risk of CA loans as compared to other 7(a) loans, SBA has determined that the current reserve requirements are insufficient with respect to CA loans sold in the secondary market. SBA is at higher risk on defaulted loans in the secondary market because SBA must make payment to the secondary market investor before it can attempt to recover any denials or repairs from the CA Lender. To address this risk, for each CA loan approved on or after October 1, 2018, a reserve of five percent of the outstanding amount of the guaranteed portion must be deposited in the LLRA if the loan is sold in the secondary market. All other requirements regarding the creation and maintenance of the LLRA stated in the February 18, 2011 notice and all subsequent notices remain unchanged, including the five percent reserve requirement on the unguaranteed portion of CA loans. Failure to maintain the LLRA as required may result in removal from the CA Pilot Program, the imposition of additional controls or reserve amounts, and/or other action permitted by SBA regulation or otherwise by law. Based on the risk characteristics or performance of a CA Lender, OCRM in its discretion and in consultation with the Director of the Office of Financial Assistance may require additional amounts to be included in the LLRA.

In the November 9, 2012 notice, SBA also modified its regulation at 13 CFR 120.660 to allow the Director, Office of Credit Risk Management instead of the Director, Office of Financial Assistance to suspend secondary market authority for CA Lenders under that regulation. Effective September 20, 2017, however, SBA amended this regulation with respect to all 7(a) Lenders to provide that suspensions and revocations under 13 CFR 120.660 would be taken by the Director, Office of Financial Assistance together with the Director, Office of Credit Risk Management. Thus, SBA's 2012

modification of 13 CFR 120.660 for purposes of the CA Pilot Program to permit the Director, Office of Credit Risk Management to take action under this regulation is no longer necessary.

g. Limitation on Fees a CA Lender May Charge

Currently, 13 CFR 120.221(a) permits a lender to charge an applicant reasonable fees (customary for similar lenders in the geographic area where the loan is being made) for packaging and other services. Under the current regulation, SBA permits lenders to charge an applicant a reasonable fee to assist the applicant with the preparation of the application and supporting materials. However, SBA does not permit lenders to charge an applicant a commitment, broker, referral, or similar fee.

For purposes of the CA Pilot Program, SBA is modifying 13 CFR 120.221(a) to limit the total fees an applicant can be charged by a CA Lender for assistance in obtaining a CA loan. Regardless of what the fee is called (*e.g.*, a packaging fee, application fee, etc.), the CA Lender is permitted to collect a fee from the applicant that is no more than \$2,500. With the exception of necessary out-of-pocket costs such as filing or recording fees permitted in §120.221(c), this is the only fee that a CA Lender may collect directly or indirectly from an applicant for assistance with obtaining a CA loan. In addition, the CA Lender may not split a loan into two loans for the purpose of charging an additional fee to an applicant.

SBA considers a fee of no more than \$2,500 to be reasonable for the services provided by a CA Lender to an applicant for assistance with obtaining a CA loan. SBA will monitor this fee and, if adjustments are necessary, SBA may revise this amount by publishing a notice with request for comment in the Federal Register.

If the CA Lender charges the applicant a fee for assistance with obtaining a CA loan, the CA Lender must disclose the fee to the applicant and SBA by completing the Compensation Agreement (SBA Form 159) in accordance with the regulation at §103.5 and the procedures set forth in SOP 50 10.

The remaining sections of 13 CFR 120.221 (sections (b) through (e)) remain unchanged. Thus, in appropriate circumstances as set forth in current §§120.221(b) through (e) and further clarified in SOP 50 10, a CA Lender may charge an applicant or borrower extraordinary servicing fees, out of pocket expenses, a late payment fee, and for legal services charged on an hourly basis.

h. Compensation and Fee Limitations Applicable to Lender Service Providers and other Agents

In the February 8, 2012 notice, SBA modified the CA Pilot Program requirements to allow CA Lenders to contract with Lender Service Providers (“LSPs”), as defined at 13 CFR 103.1(d). SBA will continue to allow CA Lenders to contract with LSPs, but is modifying some of the requirements applicable to LSPs, including total fee limits and limitations on receiving compensation from both the CA Lender and the applicant in connection with the same loan application.

SBA is modifying 13 CFR 103.4(g), which permits a limited exception to the “two master” prohibition when an Agent⁹ acts as a Packager¹⁰ and is compensated by the applicant for packaging services, and the same Agent also acts as a Referral Agent¹¹ and is compensated by the lender for those activities in connection with the same loan

⁹ Agent is defined in 13 CFR 103.1(a) as an authorized representative, including an attorney, accountant, consultant, packager, lender service provider, or any other person representing an applicant or participant by conducting business with SBA.

¹⁰ Packager is defined in 13 CFR 103.1(e) as an Agent who is employed and compensated by an Applicant or lender to prepare the Applicant's application for financial assistance from SBA. SBA determines whether or not one is a “Packager” on a loan-by-loan basis.

¹¹ Referral Agent is defined in 13 CFR 103.1(f) as a person or entity who identifies and refers an Applicant to a lender or a lender to an Applicant. The Referral Agent may be employed and compensated by either an Applicant or a lender.

application. SBA believes there is, at a minimum, an appearance of a conflict of interest when an Agent represents both the applicant and the CA Lender on the same loan application. Further, when conducting lender oversight activities, SBA has observed numerous instances where applicants have been erroneously charged for services that were provided for a lender, not the applicant. In order to prevent any conflicts of interest from arising and to ensure the applicants are not improperly charged for services provided to the CA Lender, SBA is modifying 13 CFR 103.4(g) to eliminate the exception to the “two master prohibition.” Thus, for purposes of the CA Pilot Program, an Agent, including an LSP, may not provide services to both the applicant and the CA Lender and be compensated by both parties in connection with the same loan application.

The regulation at 13 CFR 103.5 sets forth, among other things, the requirement for all Agents to disclose to SBA the compensation received for services provided to an applicant and requires that fees charged must be considered reasonable by SBA. In an effort to clarify what SBA considers reasonable and to prevent applicants from being overcharged by Agents, SBA is modifying this regulation to limit the total fees that an Agent or Agents may charge an applicant in connection with obtaining a CA loan. An Agent or Agents may charge a maximum of up to 2.5% of the CA loan amount, or \$7,000, whichever is less.

If an Agent provides more than one service to an applicant (*e.g.*, packaging and referral services), only one fee is permitted for all services performed by the Agent. Further, if more than one Agent (*e.g.*, a Packager and a Referral Agent) provides assistance to the applicant in obtaining the CA loan, the amount of all fees that the applicant is required to pay must be combined to meet the maximum allowable fee set by

SBA. (However, a fee charged to the applicant by the CA Lender in accordance with modified 13 CFR 120.221(a), as described above, will not be counted toward the maximum allowable fee for an Agent or Agents.) These maximum limits apply regardless of whether the Agent's fee is based on a percentage of the loan amount or on an hourly basis.

SBA considers a fee of the lesser of 2.5% of the guaranteed loan amount or \$7,000 to be reasonable for the services provided by an Agent or Agents to an applicant in connection with obtaining a CA loan. SBA will monitor this fee and, if adjustments are necessary, SBA may revise this amount from time to time by publishing a notice with request for comments in the Federal Register.

Finally, SBA is also modifying the last sentence in 13 CFR 103.5(c) to remove the word "directly." This change clarifies that compensation paid by the CA Lender to a Lender Service Provider may not be charged to the applicant, either directly or indirectly.

4. General Information

The changes in this Notice are limited to the CA Pilot Program only. All other SBA guidelines and regulatory waivers or modifications related to the CA Pilot Program remain unchanged. The regulatory waiver and modifications described in this Notice are authorized by 13 CFR 120.3, which provides that the SBA Administrator may suspend, modify or waive rules for a limited period of time to test new programs or ideas. These modifications apply only to loans made under the CA Pilot Program and will last only for the duration of the pilot, which expires September 30, 2022.

SBA has provided more detailed guidance in the form of a Participant Guide which is being updated to reflect these changes and will be available on SBA's website at

<http://www.sba.gov>. SBA may provide additional guidance, through SBA notices, which may also be published on SBA's website at <http://www.sba.gov/category/lender-navigation/forms-notices-sops/notices>. Questions regarding the CA Pilot Program may be directed to the Lender Relations Specialist in the local SBA district office. The local SBA district office may be found at <http://www.sba.gov/about-offices-list/2>.

Authority: 15 U.S.C. 636(a)(25) and 13 CFR 120.3.

Dated: September 4, 2018.

Linda E. McMahon,
Administrator.

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