SBA Loan Covenants: Walking the Fine Line

Talk about walking a fine line. Including loan covenants in SBA loan credit memos can help ensure the health of your portfolio in a tough economic environment. Yet what happens when the borrower fails to meet such loan covenants as requiring that the Debt Service Coverage Ratio (DSCR) doesn't drop below a certain number, liquidity ratios change, or the borrower's salary levels are above what's required in the covenant?

These situations can lead to difficulties when navigating SBA and FDIC/NCUA expectations because there's a difference between what regulators want and what the SBA wants.

As consultants, we’ve seen banks restructure, call a loan, or classify a loan when a borrower fails to meet covenant requirements like these. Is this always necessary?

Here's the low-down. The FDIC/NCUA expects lenders to take some form of action when covenants aren't met. Often, when a lender violates loan covenants, the FDIC/NCUA or state governing body will expect the lender to classify the credit, which is a reasonable requirement. Yet sometimes they will also ask why the lender hasn't acted to call the loan or increase their reserves.

On the other hand, the SBA also expects lenders to take actions, yet they don't want them to place a loan into default and liquidate it based solely on a borrower's failure to meet covenants. The SBA requires lenders to place loans in liquidation only when there's a true payment default, bankruptcy or business closure. The SBA would expect the lender to monitor these covenants and note the changes, but other actions would not be required.

As a lender, these polar opposite expectations can leave you unsure of how to proceed. And that's the rub: What covenants are reasonable when underwriting an SBA loan?
Our advice: Make prudent decisions when adding loan covenants. Ask yourself: is the covenant important enough to the overall loan to warrant the additional resources in time and paperwork when there's a violation? Loan covenants are often necessary in commercial lending. Lenders should weigh them carefully and be aware of what both regulating bodies would require when a borrower violates a covenant.

At J.R. Bruno & Associates, our team of consultants has more than 200 years of combined experience running in-house SBA departments and working with hundreds of institutions in underwriting and managing their SBA portfolios. We've seen it all! When dealing with covenants, it's best to be proactive. We're here to help talk you through possible covenants and help you determine what covenants are reasonable when underwriting an SBA loan. Feel free to call me directly at 415.362.1200 to discuss your SBA portfolio. Or visit www.jrbrunoassoc.com. We look forward to working with you!

Joanna

Joanna Bruno
President
J.R. Bruno & Associates
870 Market Street, Suite 462
San Francisco, CA 94102
415.362.1200
joanna@jrbrunoassoc.com

Visit us at www.jrbrunoassoc.com