Pros and Cons of Basing Early-Stage SBA Loans on Gross Income

small business lending underwriting PPP

Summary: Borrowing a page from the Paycheck Protection Program, some banks have begun offering microloans to early-stage businesses based on their gross income. We consider the pluses and minuses of this underwriting method.

There is a scene in the Wachowski-directed sci-fi film "Jupiter Ascending" where Jupiter, the main character, must go through a bureaucratic, laborious process to file the appropriate paperwork to stake her claim as galactic royalty, with Earth as her inheritance. In order to claim her title, she must file an inheritance petition. To do that, Jupiter must obtain a title survey, file a quick claim through central services, get Geoprint identification, and obtain a tax ID number that can't be issued without a title number — which she can't get without the tax ID number.

It's a humorous depiction of the exhausting, and at times agitating, process that filing paperwork for financial or legal agreements can be. It's also the same sort of red tape that some small business owners encountered when they attempted to apply for Paycheck Protection Program (PPP) loans during the COVID-19 pandemic. Gathering the amount of paperwork necessary was such a burden for small businesses that they had a hard time qualifying.

Overall, the PPP was a success by many measures, helping small businesses across the US survive the COVID-19 pandemic and lockdowns. By the end of May 2021, the program had issued more than 11.8MM loans. From that 11.8MM loan total, around 10.5MM have been forgiven. It did not change the fact, however, that some small businesses and entrepreneurs who needed small-balance loans were not able to get them.

To allow more borrowers access to larger loans, in March 2021 the PPP began letting lenders determine loan amounts based on gross income, rather than on net income. The change pushed more money to smaller businesses, which included independent contractors and sole proprietors, and helped PPP originate 6.7MM additional loans for $277.7B between mid-February and the beginning of May 2021, when PPP ran out of money.

The BOLT Loan Program

One FL-based CFI offers nationally available loans to small businesses through a lending program called BOLT. The BOLT loan program builds on PPP by letting banks write 7(a) microloans that consider gross rather than net income. BOLT loans last 10Ys and top out at $150K, priced at prime plus 2.75%. Borrowers need to have been in business for at least two years and have good personal and business credit scores.

Using gross income to determine loan amounts has gotten more common since the worst of the pandemic, but it's still not what lenders usually rely on to make their decisions. Kristen Conti, who owns Peacock Premier Properties in Englewood, Florida, says that many SBA lenders "*won't use gross income because it doesn't show the borrower's real ability to make the loan payments.*"

Risks and Benefits of Considering Gross Income

Loan underperformance or default is the biggest risk to banks that are writing loans to early-stage businesses based on gross income rather than net income. Cost inefficiencies due to the time and energy spent on ensuring that the credit decisions are sound, as well as growing compliance issues with potential changes to small business lending data collection by the Consumer Financial Protection Bureau (CFPB), are also challenges.

Despite these risks, the practice also brings potential benefits:

- **A way to compete against nonbank lenders.** Considering gross rather than net income gives community financial institutions (CFIs) a potential way to outcompete nonbank lenders for business from companies that need a relatively small sum to support their growth. Using gross income does not penalize the borrower for non-recurring and unusual costs that occurred under particular circumstances. Also, it gives the borrower credit for maintaining (and possibly growing) their client volume. While this is true, it is also important to note that this approach may be more applicable for businesses that typically exhibit a steady (i.e., predictable) operating expense.
- **Underwriting flexibility.** The ability to determine loan eligibility based on credit scores, business longevity, repayment history, and gross income gives CFIs more ways to say “yes” to potential loan customers.
- **An opportunity to continue PPP relationships.** After successfully applying for a PPP loan, many businesses opened accounts with their new lenders. Offering these customers another loan helps extend and deepen the relationship.
- **A stronger loan source at a time when mortgage originations are declining.** Under pressure from rising rates, mortgage applications were down 23% YoY at the beginning of September. The average rate for a 30Y fixed-rate loan was just under 5.94%, up from 3.1% in the week ending June 20, 2020. Many CFIs have relied on mortgages and their origination and processing fees as an income source. Microloans are new business at a time when mortgage quantities are slipping.
- **Building customer loyalty.** It’s challenging to navigate through a business’ early stages. Lenders that extend a hand to small companies that need cash infusions can look forward to seeing those borrowers return for the next loan or depository account.

Although the risks should be taken into consideration, offering small-business microloans based on gross rather than net income is another way to strengthen ties with your community. These loans can often provide critical capital for small businesses, as well as ensure that underserved businesses owned by women and minorities, and those in low-income areas, have the chance to become viable.

Update: *an earlier version of this BID inaccurately stated that BOLT loans are administered by the Small Business Administration. This article has been updated to reflect that BOLT loans are offered through a program provided by a Florida-based community bank.*

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ECONOMY & RATES

Rates As Of: 11/22/2022 06:44AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.41	0.19	4.35
6M	4.65	0.08	4.46
1Y	4.71	0.09	4.33
2Y	4.52	0.03	3.78
5Y	3.95	-0.28	2.69
10Y	3.80	-0.26	2.29
30Y	3.89	-0.28	1.98

FF Market	FF Disc	IORB
3.83	4.00	3.90
SOFR	**Prime**	**OBFR**
3.80	7.00	3.82