

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

Memorandum

To: Members, House Small Business Subcommittee on Investigations, Oversight and Regulations

From: Committee Staff

Date: June 18, 2012

Re: Hearing: "Small Business Lending: Perspectives from the Private Sector."

On June 21, 2012 at 10:00 a.m., the Committee on Small Business Subcommittee on Investigations, Oversight and Regulations will meet in Room 2360 of the Rayburn House Office Building for the purpose of conducting a hearing on small business lending. The hearing will address the regulatory burdens associated with lending to small business, with specific focus on the management of the Small Business Administration's (SBA's) financial assistance programs. SBA lending partners and other financial institutions will address the current state of small business lending and how the SBA can improve its processes to make its programs more successful.

Introduction

Over the past 15 years, small businesses have accounted for 65 percent of private sector job creation.¹ Given the importance of small businesses to the economy, it is important that they are given the tools they need to be successful. According to a survey conducted by Pepperdine University, 64 percent of businesses with revenue under five million dollars said that difficulty securing financing is limiting their growth potential.²

¹ BRIAN HEADD, SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, AN ANALYSIS OF SMALL BUSINESS AND JOBS (March 2010), *available at* [http://www.sba.gov/sites/default/files/files/an%20analysis%20of%20small%20business%20and%20jobs\(1\).pdf](http://www.sba.gov/sites/default/files/files/an%20analysis%20of%20small%20business%20and%20jobs(1).pdf).

² JOHN K. PAGLIA, PEPPERDINE UNIVERSITY, PEPPERDINE PRIVATE CAPITAL ACCESS INDEX SURVEY RESPONSES FIRST QUARTER 2012, (2012), *available at* http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/content/Pepperdine_PCA_firstquarter2012.pdf.

Congress created the SBA to, among other things, assist small businesses in obtaining necessary debt and equity capital. The agency accomplishes this mission through private sector partners that provide capital to small business concerns. The SBA then guarantees repayment of a portion or all (depending on the program) of the funds should the small business concern be unable to repay.

Congress delegated to the SBA substantial, but not unbridled, discretion to operate these capital access programs. The SBA carries out this responsibility through the issuance of regulations, interpretation of these regulations denominated as standard operating procedures (SOPs), and through periodic examination and review of the private sector's portfolios of loans and investments. Of particular concern, is the use of ad hoc procedures used to determine entrants to its equity capital programs and to manage the operations of private sector lenders providing debt capital to small business concerns.

SBA has been criticized by both borrowers and SBA lending partners that its procedures are cumbersome, causing delays in loan approvals. Further, uncertainty related to SBA policy and procedures deters lenders and providers of equity capital from partnering with the SBA. Moreover, audits have revealed that SBA's lender oversight does not adequately monitor risk and the agency is slow to respond to potential problems.

SBA Financing Program Participants

7(a) Loan Guarantee Program

SBA's flagship financing program is the 7(a) Loan Guarantee Program,³ which provides private lenders, typically commercial banks, with a government guarantee that a percentage of the loan will be repaid by the SBA in the event the small business borrower defaults.⁴ The guarantee allows the lender to provide financing to small businesses that would not otherwise be eligible for credit on comparable terms. This is particularly critical in times when banks reduce their private sector lending due to increased scrutiny by bank regulators.

To participate in the SBA 7(a) lending program, a bank must meet a variety of eligibility requirements, including: performing all lending functions related to small business loans; maintaining satisfactory performance; and remaining in good standing with the SBA and other federal financial regulators.⁵

³ The 7(a) program is named for the section of the Small Business Act that authorizes the program.

⁴ 13 C.F.R. § 120.2(a)(2).

⁵ *Id.* at § 120.410.

To expedite the processing and closing of a loan, some SBA lending partners have the ability to operate with a certain level of delegated authority, which allows them to perform various lending functions without pre-approval by the SBA.⁶ Certified lenders still must have their actions approved by SBA, but get priority approval by SBA processing centers.⁷ Preferred lenders are permitted to close, service and liquidate loans with reduced requirements for documentation and prior approval by SBA.⁸ This means that a preferred lender is able to obligate the federal government to honor a guarantee without any prior approval by SBA. While reducing processing times, this authority limits SBA's ability to oversee lenders on an individual loan basis.⁹

Certified Development Company Loan Program

SBA offers long-term, fixed-rate financing for plant and equipment through the Certified Development Company Loan Program, colloquially referred to as the 504 Program. In the 504 Program, non-profit organizations known as Certified Development Companies (CDCs) act on behalf of the SBA by financing a portion¹⁰ of a project by selling a debenture to investors which is 100 percent guaranteed by SBA. Loans offered by CDCs must meet certain economic development or public policy goals.

Similar to 7(a) lenders, CDCs are able to receive delegated authority from SBA. Most CDCs do not operate with any delegated authority and must have all lending functions pre-approved by SBA and some CDCs are accredited lenders that must gain pre-approval from SBA, but they receive priority when submitting documentation.¹¹ Finally, a few CDCs are designated as premier certified lenders (PCLs)¹² who not only have increased authority to process, close and service 504 loans, but they also have authority to liquidate collateral on defaulted loans without prior approval by SBA. Similar to preferred lenders in the 7(a) Program, premier certified lenders have the ability to obligate the government without pre-approval by SBA. Unlike the 7(a) loan program, the overwhelming majority of loans made by CDCs must first go through SBA approval.

⁶ According to testimony before the Senate Small Business and Entrepreneurship Committee in 2008 by SBA's Inspector General, nearly 87 percent of SBA loans were made using some level of delegated authority, SBA Lender Oversight: Preventing Loan Fraud and Improving Performance of Lenders, Testimony before the S. Comm. on Small Business and Entrepreneurship 110th Cong. 36 (2008) (Testimony of Eric M. Thorson, Inspector General, SBA before the Senate Small Business and Entrepreneurship Committee, (Nov. 13, 2007) available at <http://www.gpo.gov/fdsys/pkg/CHRG-110shrg41658/pdf/CHRG-110shrg41658.pdf>. To obtain delegated authority, lenders must meet additional criteria specified in SBA regulations. *Id.* at §§ 120.441-451.

⁷ 13 C.F.R. § 120.440.

⁸ *Id.* at § 120.450.

⁹ Regular SBA lenders must submit loan applications and servicing actions to SBA before they can issue a loan or take a servicing action against a borrower.

¹⁰ The CDC's involvement is generally 40 percent of a project financing. Banks provide 50 percent (not guaranteed by the federal government although the stimulus bill authorized temporary guarantees) and 10 percent is injected by the borrower. 15 U.S.C. § 696(3).

¹¹ 13 C.F.R. § 120.840 (providing standards for obtaining accredited status).

¹² *Id.* at § 120.846 (requirements to obtain premier certified lender status).

Pilot Programs

In addition to the programs authorized by Congress the SBA has, without specific congressional authorization, started several lending initiatives under its pilot program authority. This authority permits the SBA to start new programs so long as they do not exceed 10 percent of the authorized program level of \$17.5 billion.¹³ The programs discussed below have been initiated under that authority.¹⁴ In carrying out this authority, the SBA creates the pilot program and then asks for comment on the program. As a result, the SBA has no way of judging from the outset whether the program will operate the way it intends; and the comments received after the fact may or may not result in the SBA modifying the operation of the pilot program.

Patriot Express

Patriot Express was launched on June 28, 2007, to expand outreach to veteran-owned businesses. The maximum loan amount is \$500,000 with an interest rate of 2.25 percent to 4.75 percent over prime.¹⁵ The loans also feature expedited turnaround times for loan approvals. Applicants eligible for this program include: veterans, service-disabled veterans, active-duty service members eligible for the military's Transition Assistance Program, reservists, national guard members and spouses or widowed spouses of a service member or veteran.

Community Advantage

SBA announced the creation of the Community Advantage Pilot Program on February 18, 2011.¹⁶ This program provides capital to underserved communities by leveraging the knowledge of community-based lenders and mission-based organizations that have experience lending to minority, women-owned and startup companies in markets facing significant economic challenges.¹⁷ Lenders in this program are authorized to make loans of up to \$250,000 with SBA's standard 7(a) guarantee levels.¹⁸ Loans also offer an interest rate of prime plus four percent.¹⁹

Small Loan Advantage

Starting on February 15, 2011, any SBA preferred lender can approve loans using the new Small Loan Advantage process. Preferred Lenders have the authority to process, close, service and liquidate SBA guaranteed loans with reduced requirements for documentation and prior approval

¹³ 15 U.S.C. § 636(a)(25).

¹⁴ SBA's pilot program authority is limited to the development of lending pilot programs. There is no pilot program authority found in the Small Business Investment Act of 1958.

¹⁵ SBA, PATRIOT EXPRESS: YOUR KEY TO BUSINESS SUCCESS, available at

http://archive.sba.gov/idc/groups/public/documents/sba_program_office/sba_patriot_patriotexpress_web.pdf

¹⁶ Community Advantage Pilot Program, Notice and Request for Comment, 76 Fed. Reg. 9626 (Feb. 18, 2011).

¹⁷ *Id.* at 9627.

¹⁸ *Id.*

¹⁹ *Id.*

by SBA.²⁰ Under this pilot program, preferred lenders are authorized to make loans under \$250,000 using a two-page application. SBA has also shortened the approval time to minutes if the application is submitted electronically by a lender with delegated authority, and from 5 to 10 days for non-delegated lenders.²¹ The goal of this program is to expand the availability of small dollar loans by minimizing the paperwork and processing requirements for SBA's highest volume lending partners.

SBA Management of Financing Programs

The Small Business Act and the Small Business Investment Act of 1958 provide SBA's Administrator with the authority to promulgate rules and regulations to carry out its statutory authority.²² In addition to regulations, SBA issues SOPs that provide step-by-step guidance to program participants on how to comply with program requirements.²³ There is no requirement that the agency consult with the public or program participants prior to issuing an SOP. The SBA does not treat the SOPs as regulations subject to notice and comment rulemaking. Thus, it remains unclear whether the agency needs to comply with its own SOPs or can ignore them.²⁴ As a result, it remains a major issue of contention whether the SOPs actually are rules, whether the SBA must adhere to the SOPs and whether the SOPs should be subject to the notice and comment procedures of the Administrative Procedure Act since outside lenders and SBICs must adhere to the SOPs.

Lender SOPs

In the 7(a) and 504 loan programs, SBA regulations govern program eligibility requirements and lenders' authority to process, close and service loans. The regulations do not, however, provide detail on the process for performing underwriting functions or the specific procedures for submitting documentation to the SBA. That is provided in SOPs.

The primary SOP governing SBA lending programs is SOP 50 10, Lender and Development Company Loan Programs.²⁵ The current SOP²⁶ (including appendices) is 397 pages in length.

²⁰ 13 C.F.R. § 120.450.

²¹ <http://www.sba.gov/advantage>.

²² Section 5(b)(6) of the Small Business Act, 15 U.S.C. § 634(b)(6).

²³ SBA's Standard Operating Procedures can be found on SBA's website at the following address:

<http://www.sba.gov/about-sba-services/7481>.

²⁴ A detailed discussion of the authority that is encompassed in the SOPs is beyond the scope of this memorandum. However, interested parties should examine *United States v. Mead Corp.*, 533 U.S. 218 (2001) and its progeny as an entry point to consideration of this issue.

²⁵ Since August 2008, there have been four updates to this SOP: 50 10 5 effective Aug. 1, 2008; 50 10 5(a) effective March 1, 2009; 50 10 5(b) effective Oct. 1, 2009; 50 10 5(c) effective Oct. 1, 2010; and 50 10 5(d) effective Oct. 1, 2011. None of these updates went through notice and comment rulemaking.

²⁶ The previous version exceeded 700 pages. Even though there have been four updates in the past three and a half years, a new update is going to be posted on the SBA website.

Lenders use the SOP to learn about changes to loan program eligibility and credit requirements, as well as procedures for processing SBA loans. In addition, the SBA has SOPs governing how the agency will examine their private sector lending partners in the 7(a) and 504 loan programs.

SBA Lender Oversight

SBA monitors lenders²⁷ based on the magnitude of risk within the respective loan programs, with large-dollar volume lenders receiving increased oversight.²⁸ Through a system of off-site data monitoring and on-site reviews, SBA reviews lenders for compliance with loan program requirements, SBA portfolio performance, credit quality and financial condition.²⁹ Monthly reports are filed by lenders with SBA containing information about its SBA loan portfolio. These reports,³⁰ referred to as 1502 Reports, provide SBA with data about the status of payments on a loan including whether the loan is current or whether there are any payments past due. SBA conducts on-site reviews of lenders with portfolios greater than \$10 million.³¹ On-site reviews examine lenders for portfolio performance, SBA operations management, credit administration and compliance with loan program requirements.³² For lenders not regulated by another federal regulatory agency, on-site examinations for safety and soundness include evaluations of capital adequacy, asset quality, management quality, earnings, liquidity, and compliance with loan program requirements.³³

SBA also develops a risk portfolio for each lender by using a data monitoring system known as the Loan and Lender Monitoring System (LLMS). This system divides lenders by peer group into one of five categories based on risk. Lenders rated a one, two or three have an acceptable risk rating, and lenders rated four or five have a less than acceptable risk rating. LLMS was created in response to the Small Business Programs Improvement Act of 1996 that required SBA

²⁷ SBA performs oversight with the assistance of three contractors. First, SBA contracts with a third party for a variety of data collection and fee collection services based on the monthly reports from lenders on the status and balance of all 7(a) loans in their portfolio. Second, SBA contracts with a third party for development and management of its risk based data monitoring system, LLMS. Finally, SBA contracts with a third party to conduct on-site reviews of lenders.

²⁸ SBA, SMALL BUSINESS ADMINISTRATION STANDARD OPERATING PROCEDURE 50 53 OFFICE OF CREDIT RISK MANAGEMENT LENDER SUPERVISION AND ENFORCEMENT 4 (SOP 50 53) (Oct. 1, 2010) *available at* http://www.sba.gov/sites/default/files/SOP-50-53_1.pdf.

²⁹ *Id.* at 5.

³⁰ Monthly reporting by lenders is referred to as 1502 reporting, named after the SBA Form 1502 Guarantee Loan Status and Remittance.

³¹ Business Loan Program; Lender Examination and Review Fees, 72 Fed. Reg. 25,189, (May 4, 2007).

³² 13 C.F.R. § 120.1050(a).

³³ *Id.* at § 120.1051(b).

to develop³⁴ a risk management database.³⁵ Even though the SBA has a tiered monitoring system, the SBA has not used this methodology to suspend or ban any lender from its program. As a result, this calls into question the utility of the LLMS and more significantly SBA lender oversight.

Problems with Management of Capital Access Programs

SOP Updates

A criticism of SBA is that its procedures for entering and maintaining status in its capital access programs are cumbersome requiring private sector partners to expend significant resources.³⁶ While SBA has attempted to streamline its procedures, they have done so without industry input or notice and comment rulemaking. The lack of industry input has led to processing delays because of problems not contemplated by SBA that would have been uncovered through notice and comment rulemaking. As a result, SBA has been forced to continually update its SOPs to address these problems.³⁷

Adding to the compliance costs for lenders is that SBA has not followed a consistent schedule for updating SOPs. While SOPs for the 7(a) and 504 programs are continually updated, which creates its own problems, other program SOPs have languished.

SBA's use of SOPs to adopt policy changes and its failure to consistently update SOPs may lead to ad hoc decision making. This occurs when similarly situated lenders are treated differently when the SOPs are applied, or not applied, to them. Such ad hoc decision making has been barred since 1946 when Congress enacted the Administrative Procedures Act.³⁸

Lending Portfolio Risk

Even more problematic than ad hoc decision making through SOPs are the findings by SBA's Inspector General that the SBA fails to adequately manage risk in its lending portfolios. A 2010 Inspector General report³⁹ on PCLs found that CDCs with the highest level of delegated

³⁴ To develop this system, SBA contracted with Dunn and Bradstreet with scoring models created by Fair Isaac, SBA OFFICE OF INSPECTOR GENERAL SBA'S USE OF THE LOAN AND LENDER MONITORING SYSTEM 1 (2007), (Report No. 7-21), available at http://www.sba.gov/sites/default/files/oig_bll0_7-21.pdf.

³⁵ *Id.* at 2.

³⁶ *Land of Opportunity: Pursuing the Entrepreneurial American Dream: Hearing Before the H. Comm. on Small Business*, 112th Cong. 17 (2011) (Statement of Jesse Torres, President and Chief Executive Officer, Pan American Bank), available at <http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg71787/pdf/CHRG-112hhrg71787.pdf>.

³⁷ SBA, OFFICE OF INSPECTOR GENERAL, PROBLEMS WITH SBA'S DIRECTIVE SYSTEM, 3 (Report No. 3-28) (2003) available at http://archive.sba.gov/idc/groups/public/documents/sba/oig_reptbydate_03-28.pdf.

³⁸ See *Morton v. Ruiz*, 415 U.S. 199, 232 (1974).

³⁹ SBA OFFICE OF INSPECTOR GENERAL AUDIT OF PREMIER CERTIFIED LENDERS IN THE SECTION 504 LOAN PROGRAM (2010) (Report No. 10-10), available at http://www.sba.gov/sites/default/files/oig_report_10-10.pdf.

authority in the 504 Loan Program had insufficient underwriting and loan closing procedures.⁴⁰ Issues found in the underwriting process included using poor methods for determining the cash flow of a business, relying on inflated sales forecasts and understating expenses.⁴¹ Issues with closing procedures included failure to achieve program requirements related to economic development and job creation.⁴² In addition, the report found that despite the PCL's non-profit status, executives were paying themselves unreasonably high-salaries, rather than reinvesting excessive income back into the community as required by statute.⁴³

Adding to SBA's programmatic risk is the agency's failure to remove lenders from its programs when problems arise. SBA's Inspector General testified before the Senate Small Business and Entrepreneurship Committee in 2008 that SBA may be "reluctant" to take enforcement action against a high volume lender because its focus has been on growing its lending portfolio. This testimony came on the heels of a case where SBA refused to remove a 7(a) lender's delegated authority after senior management officials were indicted.⁴⁴

Conclusion

For its financing programs to be successful, SBA needs to be more transparent with its lending partners about the management of its programs. It is lending partners who deploy the SBA programs and who work with small businesses to arrange financing. In addition, financial institutions, not currently partnering with SBA, need to have faith in SBA before they spend the resources necessary to train their staff on how to make a loan with an SBA guarantee. To ensure the viability of its lending programs, it is imperative that SBA address concerns by lending partners about ad hoc procedures used by the agency and develop a consistent decision making process as required by the Administrative Procedures Act.

⁴⁰ *Id.* at 4.

⁴¹ *Id.*

⁴² *Id.* at 8.

⁴³ *Id.* at 15.

⁴⁴ *SBA Lender Oversight: Preventing Loan Fraud and Improving Performance of Lenders, Testimony before the S. Comm. on Small Business and Entrepreneurship, 110th Cong. 36 (2008) (Statement of Eric M. Thorson, Inspector General, SBA before the Senate Small Business and Entrepreneurship Committee, (Nov. 13, 2007) available at <http://www.gpo.gov/fdsys/pkg/CHRG-110shrg41658/pdf/CHRG-110shrg41658.pdf> .*