

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

To: Members, Committee on Small Business  
From: Small Business Committee Staff  
Subject: Full Committee Hearing: "Oversight of the Small Business Administration  
Financing Programs"  
Date: October 25, 2011

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On Wednesday, October 26, 2011, at 1:00 pm, in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for the purpose of examining the Small Business Administration's (SBA) programs that provide capital to small business. The hearing will focus on the SBA's fiscal year 2011 performance in supplying needed financing to small businesses. SBA Administrator Karen Mills will provide testimony on the first panel and private sector partners with the SBA will be on the second panel.

### **Introduction**

In fiscal year 2008, SBA saw a decline in its lending volume as a result of the near collapse of the financial services sector. The resulting downturn left slow growth and high unemployment throughout the country. The banks, in part due to lack of confidence in the economic outlook and partially in response to stricter oversight by regulators, tightened credit. From 2008 to 2010, small business lending by depository institutions declined by 8.3 percent to \$652 billion.<sup>1</sup> To get the economy moving again, several laws were enacted that offered a mix of temporary and permanent programs intended to put money into the hands of consumers and businesses. Several of the new laws focused on the financing programs offered by the SBA, whose traditional role is to provide capital to small businesses which cannot otherwise obtain credit. On October 5, 2011,

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<sup>1</sup> OFFICE OF THE CHIEF COUNSEL FOR ADVOCACY, LENDING BY DEPOSITORY LENDERS TO SMALL BUSINESSES 2003 TO 2010 8 (2011), available at <http://www.sba.gov/sites/default/files/rs380tot.pdf>.

SBA announced that during fiscal year 2011, agency-backed loans supported over \$30.5 billion in lending to small business, the highest volume year in SBA's history.<sup>2</sup>

## SBA Loans

### *The 7(a) Loan Guarantee Program*

Traditionally, small firms have difficulty obtaining loans because they lack a past history of performance.<sup>3</sup> The public policy goal for risking taxpayer dollars is that the government should aid small businesses in obtaining access to capital because of their important contribution to economic growth.<sup>4</sup> SBA's flagship financing program is the 7(a) Loan Guarantee Program.<sup>5</sup> In the 7(a) Program, loans are not made directly by the SBA; rather, commercial lenders underwrite, issue and service the loan to a small business which is then guaranteed by the SBA. The size of the government guarantee varies depending on the size of the loan, with loans under \$150,000 receiving a guarantee of 85 percent and loans exceeding \$150,000 receiving a 75 percent guarantee. The government guarantee mitigates some of the risk that a lender takes on when lending to a small business. The maximum loan amount is \$5 million and interest rates vary depending on the size and length of the loan. Most loans provided in the 7(a) loan program are issued by preferred lenders who process, close, service, and liquidate loans without pre-approval by SBA.<sup>6</sup>

### *Community Development Company Loan Program*

SBA's Community Development Company (CDC) Loan Program provides long-term, fixed-rate financing for major fixed assets (land, equipment, machinery, etc.).<sup>7</sup> The structure for financing an asset through this program is: a loan from a commercial lender covering 50 percent of a project cost, secured by a senior lien which allows the lender to be paid first in the event of a liquidation; a loan from a Certified Development Company (CDC), which is a private, nonprofit corporation whose primary mission is economic development, that covers 40 percent of the cost through the issuance of a debenture, whose repayment is guaranteed by SBA and sold to an investor; and finally, the borrower must contribute 10 percent of the cost of the project.<sup>8</sup> The

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<sup>2</sup> SMALL BUSINESS ADMINISTRATION, JOBS ACT LOAN INCENTIVES LED TO RECORD SBA BACKED LOAN APPROVAL VOLUME, SUPPORTING OVER \$30 BILLION IN SMALL BUSINESS LENDING, PRESS RELEASE NO. 11-58, (October 5, 2011), available at <http://www.sba.gov/about-sba-services/7367/27101>.

<sup>3</sup> GOVERNMENT ACCOUNTABILITY OFFICE, SMALL BUSINESS ADMINISTRATION: 7(A) LOAN PROGRAM NEEDS ADDITIONAL PERFORMANCE MEASURES, GAO 08-226T, 9 (Nov. 1, 2007) available at <http://www.gao.gov/new.items/d08226t.pdf>.

<sup>4</sup> 15 U.S.C. § 631.

<sup>5</sup> *Id.* at 636(a)(1)(A).

<sup>6</sup> 13 C.F.R. § 120.450.

<sup>7</sup> 15 U.S.C. §§ 695-97g. These are often referred to, incorrectly, as "504" loans.

<sup>8</sup> 13 C.F.R. § 120.2(c).

CDC portion of the loan is secured by a junior lien which means SBA is repaid only after the first lien position of the commercial lender is satisfied in the case of default.<sup>9</sup> For an asset to be financed through this program, specific job creation and public policy goals must be met.<sup>10</sup>

### *Small Business Investment Company Program*

The Small Business Investment Company (SBIC) program is a public-private partnership whose goal is to stimulate the flow of private equity capital to small businesses. After raising sufficient private capital (a minimum of \$5 million) these companies submit plans to the SBA detailing their investment strategies in small business.<sup>11</sup> Once they are approved, they receive a license. The license entitles the SBICs to obtain “leverage” from the SBA at up to three times the amount of capital.<sup>12</sup> The leverage is obtained by the sale of a note (denominated as a debenture) to private investors, and the private investors are guaranteed repayment on the note by the SBA.<sup>13</sup> In essence, private investors are lending the SBIC funds, and the SBIC repays the SBA out of earnings on the SBIC’s investment in various small businesses. There are a variety of regulatory restrictions to ensure that the government is protected. Those restrictions include the ability to limit the total amount of leverage, the placement of a SBIC in receivership, and the structure of repayments between the SBIC and the SBA.<sup>14</sup>

### *Microloans*

The SBA’s Microloan Program is designed to assist startup small businesses by providing low dollar loans.<sup>15</sup> The SBA does not make microloans directly to small businesses. Rather, the SBA makes a loan to a non-profit called a microloan intermediary.<sup>16</sup> The intermediary then makes loans of up to \$50,000 to small business borrowers.<sup>17</sup> The microloan intermediary makes money because the SBA subsidizes the interest rate of loans made to the intermediaries who then charge borrowers market-level interest rates.<sup>18</sup> The primary difference between this program and the 7(a) Loan Program is that intermediaries provide ongoing education and training to their small business borrowers.

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<sup>9</sup> In a non-default situation, the lien status for repayment is irrelevant.

<sup>10</sup> 15 U.S.C. § 695(d)-(e).

<sup>11</sup> *Id.* at § 681.

<sup>12</sup> *Id.* at § 683(b)(1).

<sup>13</sup> *Id.* at § 683(b).

<sup>14</sup> 13 C.F.R. § 107.1810.

<sup>15</sup> 15 U.S.C. § 636(m).

<sup>16</sup> *Id.* at § 636(m)(1)(B).

<sup>17</sup> *Id.* at § 636(m)(1)(B)(iii), as amended by § 1113 of the Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2508 (hereinafter “Small Business Jobs Act”)

<sup>18</sup> *Id.* at § 636(m)(3)(F).

## Small Business Jobs Act

The first law enacted to help small businesses recover from the financial crisis was the American Recovery and Reinvestment Act of 2009.<sup>19</sup> This law created several temporary programs at SBA and made several temporary changes to current SBA financing programs. The changes made by this Act are, for the most part, no longer in existence and will not be discussed any further except as otherwise noted.

A second small business stimulus, the Small Business Jobs Act of 2010, was signed into law on September 27, 2010.<sup>20</sup> This law made permanent changes to existing financing programs and created new programs designed to enhance small business access to capital. It also increased the maximum loan amount to \$5 million from \$2 million for SBA's loan guarantee program.<sup>21</sup> For SBA's CDC program, the law increased the maximum project amount to \$5 million from \$1.5 million for regular borrowers, to \$5 million from \$2 million if loan proceeds are directed towards a specified public policy goal, and to \$5.5 million from \$4 million for manufacturers.<sup>22</sup> Finally in the Microloan Program, the maximum loan amount to an intermediary was increased to \$5 million from \$3.5 million, and the maximum amount of a loan to a borrower was increased to \$50,000 from \$35,000.<sup>23</sup> The Act also created some temporary programs.

### *CDC Refinancing Program*

The Small Business Jobs Act of 2010 created a two-year temporary authorization, set to expire on September 27, 2012, that permits CDCs to refinance existing non-governmental debt; i.e., debt not issued by the SBA or any other federal agency.<sup>24</sup> Typically, borrowers who have commercial mortgages need to refinance because their original loans were short-term financing for construction.<sup>25</sup> After the financial crisis commenced in 2007, commercial real estate faced the same problem that residential real estate purchasers faced – the value of their property was worth less than the mortgage they needed to refinance. The expectation for the CDC refinancing program was to mimic the three-part structure of the CDC program, including federal guarantees for 40 percent of the value of the debt to refinance commercial real estate in an effort to prevent foreclosures in that market.

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<sup>19</sup> Pub. L. No. 111-5, 123 Stat. 115, 150-161 (2009).

<sup>20</sup> Pub. L. No. 111-240, 124 Stat. 2504 (2010) (hereinafter "Small Business Jobs Act").

<sup>21</sup> *Id.* at § 1111, 124 Stat. 2507.

<sup>22</sup> *Id.* at § 1112, 124 Stat. 2508.

<sup>23</sup> *Id.* at § 1113, 124 Stat. at 2508.

<sup>24</sup> *Id.* § 1122, 124 Stat. at 2510.

<sup>25</sup> D. LONG & W. ARCHER, REAL ESTATE PRINCIPLES: A VALUE APPROACH 655-58 (2005).

Three major potential problems exist with this program. First, unlike the traditional CDC program, the refinancing program requires no job creation or savings at all.<sup>26</sup> Second, the borrower need not supply any cash contribution as the SBA has determined that the property can serve as the borrower's contribution.<sup>27</sup> Most significantly, the program is using federal funds to guarantee the refinancing of property whose value has deteriorated, thereby placing taxpayers at significant risk for loss on properties that do not even necessarily contribute to economic development and growth.

### *Dealer Floor Plan Financing*

Using inventory that is sold to consumers as collateral for a loan to enable a business to purchase inventory is a common financing technique used by car, boat, recreational vehicle, furniture, and appliance dealers among others. This is called floor plan financing because the businesses are purchasing inventory that will be placed on their showroom floor. Historically, the SBA did not permit the use of loan proceeds to purchase inventory, even if the inventory is used as collateral for the loan. *See* 13 C.F.R. § 120.130(c) (2008). In 2009, the SBA created a pilot program (without congressional authorization or comment from the public) to permit floor plan financing for products that receive titles from states, such as automobiles, boats, manufactured homes and motorcycles.<sup>28</sup> The Small Business Jobs Act of 2010 created a statutory authorization for the program and limited it to automobiles, recreational vehicles, boats, and manufactured homes with higher loan limits than provided by the agency in its July 2009 notice.<sup>29</sup>

### *Intermediary Lending Pilot Program*

Authorized under the Small Business Jobs Act of 2010, the Intermediary Lending Pilot Program authorizes the SBA to provide direct loans up to \$1 million at an interest rate of one percent to 20 community organizations or intermediaries for a term of 20 years.<sup>30</sup> The loan recipients will, in turn, make loans of up to \$200,000 to start-up small businesses in underserved markets.<sup>31</sup> This program was designed to increase the availability of capital to newly established or growing small businesses.<sup>32</sup> Intermediaries are selected on a competitive basis and must show that they are trying to serve impoverished or poor communities.<sup>33</sup> In short, the program simply represents

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<sup>26</sup> Section 1122 of the Small Business Jobs Act authorized but did not require the SBA to make loans without regard to the normal job creation requirements needed for conventional CDC loans. The SBA elected that option in implementing § 1122. Small Business Jobs Act; 504 Loan Program Debt Refinancing, Interim Rule, 76 Fed. Reg. 9213, 9215 (Feb. 17, 2011).

<sup>27</sup> *Id.* at 9214.

<sup>28</sup> Dealer Floor Plan Pilot Initiative, Notice, 74 Fed. Reg. 32,006 (July 6, 2009). The SBA requested comment on the program *after* the agency created it.

<sup>29</sup> Small Business Jobs Act, § 1133, 124 Stat. at 2514-15.

<sup>30</sup> Small Business Jobs Act, § 1131, 124 Stat. at 2512.

<sup>31</sup> *Id.*, 124 Stat. at 2513-14.

<sup>32</sup> Intermediary Lending Pilot Program, Interim Rule, 76 Fed. Reg. 18,007, 18,008 (Apr. 1, 2011).

<sup>33</sup> *See* 13 C.F.R. § 109.200(b)(3), *reprinted in* 76 Fed. Reg. at 18,016.

another mechanism to expand the number of potential intermediaries that, after the pilot program is over, can move to the Microloan Program.

## **Lending Initiatives**

In addition to the programs authorized by Congress, the SBA without specific congressional authorization, has 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.<sup>34</sup> The programs discussed below have been initiated under that authority.<sup>35</sup> 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.

### *Community Advantage*

SBA announced the creation of the Community Advantage Pilot Program on February 18, 2011.<sup>36</sup> 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.<sup>37</sup> Lenders in this program are authorized to make loans of up to \$250,000 with SBA's standard 7(a) guarantee levels.<sup>38</sup> Loans also offer an interest rate of prime plus four percent.<sup>39</sup>

### *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 by SBA.<sup>40</sup> 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.<sup>41</sup> The goal of this program is to expand the

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<sup>34</sup> 15 U.S.C. § 636(a)(25).

<sup>35</sup> 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.

<sup>36</sup> Community Advantage Pilot Program, Notice and Request for Comment, 76 Fed. Reg. 9626 (Feb. 18, 2011).

<sup>37</sup> *Id.* at 9627.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> 13 C.F.R. § 120.450.

<sup>41</sup> <http://www.sba.gov/advantage>.

availability of small dollar loans by minimizing the paperwork and processing requirements for SBA's highest volume lending partners.

### *Impact Investment Initiative*

Impact Investments are SBIC licensees that pledge to provide 50 percent of their capital to investments that target either a place-based or sector-based national priority.<sup>42</sup> Place-based investments must target areas with low or moderate income or areas that are economically distressed. Sector-based investments must target national priorities which currently include clean energy or education.<sup>43</sup> To participate in this program, SBA is offering expedited licensing times and the option of being included on a list of funds that is provided to institutional investors who express interest in impact investing.<sup>44</sup> It is unclear whether the SBA has the authority to set the priorities in this program under Title III of the Small Business Investment Act of 1958.

### *Early Stage Innovation Fund*

SBA plans to announce the terms for participation in an initiative to assist high-growth small businesses. This initiative will use the infrastructure of the SBIC program to provide capital to SBIC funds that target early-stage firms that fail because they are unable to access equity capital in the "Valley of Death," which is the period when companies are often seeking their first dollar of institutional capital.<sup>45</sup> SBA expects to make the program announcement in early fiscal year 2012.<sup>46</sup> As with the Impact Initiative, it remains unclear what authority the SBA has to create this preference in the SBIC program.

## **SBA Oversight and Management of its Financing Programs**

Along with providing small businesses access to capital, the SBA is also responsible for oversight of participants in all of its financing programs. This is an important mission since the government guarantees various financial instruments held by the public who have provided capital to small businesses. In fiscal year 2011, a top priority of SBA was to increase participation in its lending programs.<sup>47</sup> According to SBA, there are 3,484 active lenders participating in the 7(a) loan program.<sup>48</sup>

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<sup>42</sup> SMALL BUSINESS ADMINISTRATION, IMPACT INVESTMENT SMALL BUSINESS INVESTMENT COMPANY ("SBIC") FUND CALL FOR ACTION, *available at* [http://www.sba.gov/sites/default/files/files/Impact\\_Investment\\_Call\\_for\\_Action.pdf](http://www.sba.gov/sites/default/files/files/Impact_Investment_Call_for_Action.pdf).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> <http://www.sba.gov/node/15261>.

<sup>46</sup> *Id.*

<sup>47</sup> Letter from Karen Mills, Administrator, Small Business Administration to Sam Graves, Chairman, House Committee on Small Business (Oct. 6, 2011) (on file with the House Committee on Small Business).

<sup>48</sup> *Id.*

### *Lender Oversight*

To participate in the 7(a) Program, a lender must maintain its ability to process, close, disburse, service and liquidate small business loans.<sup>49</sup> A CDC, on the other hand, must package, process and service loans and is only permitted to liquidate loans if authorized to do so by SBA.<sup>50</sup> These lending functions must take place in accordance with all SBA program requirements imposed on lenders and CDCs by statute, regulations, agreements, programs notices and standard operating procedures.<sup>51</sup> SBA performs its oversight function through a risk-rating system that rates participants on a one-to-five scale based on a mix of past, current and predictive performance measures. A risk rating of one, two, or three means that a lender's performance is satisfactory, while a rating of four or five represents a less than satisfactory risk rating. SBA supplements its risk-rating system with onsite examinations, where examiners travel to a lender or CDC to review loan files and other documents to insure compliance with SBA loan program requirements.<sup>52</sup> For SBA lenders not regulated by another federal regulator, SBA acts as the primary regulator. These lenders have additional compliance requirements that include maintaining proper internal and management controls over operations, audit procedures, and capital requirements.<sup>53</sup> As a result of examinations, SBA may take action against a financial institution to make them more secure or suspend them from participation in the lending programs.<sup>54</sup>

### *SBIC Oversight*

SBA is also responsible for oversight of licensed funds in the SBIC program. To maintain their license, SBIC funds are responsible for compliance with program eligibility requirements that include numerous reporting requirements.<sup>55</sup> To ensure compliance with the regulatory requirements, SBA conducts periodic examinations to ensure that funds are not placing the government at undue risk.<sup>56</sup> SBA also exercises oversight of funds through its control on the issuance of leverage. The SBA only will issue leverage (even if the SBIC has purchased a commitment for leverage) when the SBIC demonstrates that it needs the leverage.<sup>57</sup> Finally, the SBA can stop the SBIC from making investments if the investment losses are sufficiently severe to place the company in "capital impairment."<sup>58</sup>

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<sup>49</sup> 13 C.F.R. § 120.410.

<sup>50</sup> *Id.* at § 120.826.

<sup>51</sup> *Id.* at § 120.10.

<sup>52</sup> *Id.* § 120.1050.

<sup>53</sup> *Id.* at §§ 120.460-.65.

<sup>54</sup> *Id.* at § 120.1400.

<sup>55</sup> *Id.* at §§ 107.630-.680.

<sup>56</sup> *Id.* at § 107.690.

<sup>57</sup> *Id.* at § 107.120(a).

<sup>58</sup> *Id.* at § 107.1830-.50.



## **Conclusion**

At the hearing, the Committee will hear testimony from SBA Administrator Mills regarding the effectiveness of SBA's financing programs. Specifically, Committee members will have the opportunity to inquire about whether the SBA programs are meeting the goal of filling a void in the private lending market, rather than competing against the private market. Further, to ensure that taxpayer dollars are being used efficiently, the Committee will learn about SBA's efforts to safeguard against poor underwriting and investment decisions by its private sector financing partners who benefit from the issuance of federal guarantees.