

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 Committee on Small Business
From: Committee Staff
Date: June 4, 2012
Re: Hearing: "SBA's Management of its Capital Access Programs."

On June 6, 2012 at 2:00 p.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of conducting an oversight hearing on the Small Business Administration's (SBA's) financial assistance programs. The hearing will address SBA's oversight of the capital access programs with a special focus on the ad hoc procedures used to manage those programs. SBA Administrator Karen Mills will provide testimony.

Introduction

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,¹ 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.² 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 concerns from 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.³

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.⁴ Certified lenders still must have their actions approved by SBA, but get priority approval by SBA processing centers.⁵ Preferred lenders are permitted to close, service and liquidate loans with reduced requirements for documentation and prior approval by SBA.⁶ 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

¹ The 7(a) program is named for the section of the Small Business Act that authorizes the program.

² 13 C.F.R. § 120.2(a)(2).

³ *Id.* at § 120.410.

⁴ 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.

⁵ 13 C.R. R. § 120.440.

⁶ *Id.* at § 120.450.

processing times, this authority limits SBA's ability to oversee lenders on an individual loan basis.⁷

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 portion⁸ 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.⁹ Finally, a few CDCs are designated as premier certified lenders (PCLs)¹⁰ 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.

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 equity capital to small businesses. There are two SBIC programs, the debenture program and the participating security program.¹¹ To be licensed as a SBIC, a fund must raise private capital and submit an application to SBA detailing their investment strategies in small business.¹² Once approved, the license entitles the SBICs to obtain "leverage" from the SBA at up to three times the amount of private capital.¹³ SBICs repay the leverage to the SBA out of earnings on their portfolio of small business investments. Individual investment decisions are left up to the SBIC.

⁷ 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.

⁸ 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).

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

¹⁰ *Id.* at § 120.846 (requirements to obtain premier certified lender status).

¹¹ The difference between the debenture program and the participating security program is how the SBA is repaid. The details of the repayment schemes are arcane and not relevant to the thrust of the hearing. However, the distinctions in repayment lead to investment at different stages of a business.

¹² 15 U.S.C. § 681.

¹³ *Id.* at § 683(b)(1).

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.¹⁴

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.¹⁵ In addition to regulations, SBA issues SOPs that provide step-by-step guidance to program participants on how to comply with program requirements.¹⁶ 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.¹⁷ 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.¹⁸ The current SOP¹⁹ (including appendices) is 397 pages in length. 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.

¹⁴ 13 C.F.R. § 107.1810.

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

¹⁶ SBA's Standard Operating Procedures can be found on SBA's website at the following address:

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

¹⁷ 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.

¹⁸ 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.

¹⁹ 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.

SBIC SOPs

The SOPs for the SBIC Program govern the structure of SBA's Investment Division, and the operational requirements for SBIC licensees. However, the SBIC license application process also requires the applicant to complete several forms including an extensive Management Assessment Questionnaire which includes over 400 questions about the structure of the fund and its investment strategy.²⁰ The SOP for SBIC license application, 10 04, issued in 1985, does not cover applications for the participating security program (which commenced operation in 1992), and specifies procedures long-abandoned by the SBA. Despite the SOPs, SBA lacks procedures for determining the initial licensing process for SBICs, leaving applicants confused about the review process and SBA vulnerable to criticism that its process for approval of a license is arbitrary.

The SBA website currently lists 25 SOPs. However, there are SOPs governing program operations that are not available on the agency's website.²¹ The lack of consistent procedures for updating SOPs and notifying the public of changes to programs could potentially mean that SBA could update procedures without finance partners knowing of the new requirements. Moreover, the SBA's cavalier disregard of its own SOPs calls into question whether the finance partners would be required to comply with their strictures if challenged in court. Ultimately, this could increase risk to the taxpayers as businesses ignore practices the SBA believes protect the federal government in case of default.

SBA Lender Oversight

SBA monitors lenders²² based on the magnitude of risk within the respective loan programs, with large-dollar volume lenders receiving increased oversight.²³ 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.²⁴ Monthly

²⁰ SBA, SBIC MANAGEMENT ASSESSMENT QUESTIONNAIRE AND SBIC LICENSE APPLICATION (Form 2181), available at <http://www.sba.gov/sites/default/files/SBA%20Form%202181.pdf>.

²¹ Additional SOPs have been sent to Committee staff but are not posted on the SBA Website <http://www.sba.gov/about-sba-services/7481>.

²² 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.

²³ 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.

²⁴ *Id.* at 5.

reports are filed by lenders with SBA containing information about its SBA loan portfolio. These reports,²⁵ 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.²⁶ On-site reviews examine lenders for portfolio performance, SBA operations management, credit administration and compliance with loan program requirements.²⁷ 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.²⁸

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 to develop²⁹ a risk management database.³⁰ 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.

SBA is 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.³¹ To ensure compliance with the regulatory requirements, SBA conducts periodic examinations to ensure that funds are not placing the government at undue risk as a result of their investments.³²

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.³³

²⁵ Monthly reporting by lenders is referred to as 1502 reporting, named after the SBA Form 1502 Guarantee Loan Status and Remittance.

²⁶ Business Loan Program; Lender Examination and Review Fees, 72 Fed. Reg. 25,189, (May 4, 2007).

²⁷ 13 C.F.R. § 120.1050(a).

²⁸ *Id.* at § 120.1051(b).

²⁹ 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.

³⁰ SBA OFFICE OF INSPECTOR GENERAL SBA'S USE OF THE LOAN AND LENDER MONITORING SYSTEM 2 (2007), (Report No. 7-21), available at http://www.sba.gov/sites/default/files/oig_bll0_7-21.pdf.

³¹ 13 C.F.R. §§ 107.630-.680.

³² *Id.* at § 107.690.

³³ *Id.* at § 107.120(a).

Finally, the SBA can stop the SBIC from making investments if the investment losses are sufficiently severe to place the company in "capital impairment."³⁴ This means that SBA has the authority to restrict the dividends that the fund can distribute to investors. SBA also has the authority to place a fund in receivership, taking control of the fund and winding it down in a way that protects the taxpayers.

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.³⁵ 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.³⁶

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. In the SBIC Program, as already noted, the application process for funds is governed by SOP 10 04 from 1985. The SOP addressing SBIC examinations has not been updated since 1997³⁷ despite several new programs within the SBIC Program being created, including pilot programs within the past year.

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 or SBICs 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

³⁴ *Id.* at §§ 107.1830-.50.

³⁵ *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>.

³⁶ 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.

³⁷ SBA, SOP 10 08 SBIC EXAMINATION GUIDELINES (SOP 10 08) (1997) available at <http://www.sba.gov/sites/default/files/sop1008.pdf>.

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

Inspector General report³⁹ on PCLs found that CDCs with the highest level of delegated 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 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

SBA is responsible for overseeing a credit and equity portfolio of more than \$90 billion. Given the risk to the taxpayers, it is imperative that SBA address the remaining outstanding recommendations made by the Inspector General related to lender oversight. Furthermore, ad hoc procedures used by the agency undermines the principles of rational and consistent decision making required by the Administrative Procedures Act potentially increasing risk to taxpayers as processes set out in SOPs are not enforced across the capital access programs.

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.

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> .