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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

Memorandum

To:	Members, Committee on Small Business
From:	Committee Staff
Date:	January 16, 2018
Re:	Hearing: "Strengthening SBA's 7(a) Loan Program"

On Wednesday, January 17, 2018 at 11:00 a.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the United States Small Business Administration's (SBA) 7(a) Loan Program and how changes proposed in H.R. 4743, the "Small Business 7(a) Lending Oversight Reform Act of 2018," could strengthen oversight and bolster the integrity of the program for small businesses and American taxpayers. H.R. 4743 is a bipartisan and bicameral SBA lending reform bill introduced by Chairman Steve Chabot (R-OH) and Ranking Member Nydia Velázquez (D-NY) as a result of numerous hearings. The hearing will provide the opportunity for Members of the Committee to hear directly from lenders participating in the program.

I. Introduction

Since the end of the Great Recession in the summer of 2009,[1] the United States economy has slowly been improving.[2] Recent trends, such as growth in small business optimism scores[3] and a decreasing unemployment rate,[4] indicate overall economic confidence. Despite promising macroeconomic conditions, the lending and financial environment continue to remain stagnant for businesses.[5] For small businesses, which regularly utilize commercial bank borrowing for expansion projects and other endeavors, a tepid lending environment is troubling. With capital options limited, small businesses often turn to the SBA to finance their undertakings. As a way to bridge the lending gaps that exist in the marketplace for the nation's smallest firms, the SBA administers several capital access programs, including its flagship program, the 7(a) Loan Program.

[1] ROBERT RICH, FEDERAL RESERVE BANK OF NEW YORK, THE GREAT RECESSION, FEDERAL RESERVE HISTORY (2013), *available at* https://www.federalreservehistory.org/essays/great_recession_of_200709.
[2] https://fred.stlouisfed.org/series/A191RL1Q225SBEA.
[3] NATIONAL FEDERATION OF INDEPENDENT BUSINESS: DECEMBER 2017 REPORT: SMALL BUSINESS OPTIMISM INDEX (2017), *available at* https://www.nfib.com/surveys/small-business-economic-trends/.
[4] https://data.bls.gov/timeseries/LNS14000000.
[5] https://fred.stlouisfed.org/series/CILACBQ158SBOG.

II. The 7(a) Loan Program

In order to increase access to capital, the SBA offers small firms guarantees through private lenders that participate in the 7(a) Loan Program, whereby loan proceeds can be used for general business purposes. The program does not provide direct loans to participating small businesses; rather, SBA guarantees the repayment of loans made by lenders. The maximum loan a small business can acquire is $5 million[6] and the guarantee percentage ranges from 75 to 85 percent based on the loan amount.[7]

The SBA charges lenders an upfront fee to run the loan program and cover any losses to protect the American taxpayer in accordance to the 1990 Federal Credit Reform Act (FCRA).[8] While varying depending on loan size, the maximum fee is capped at 3.75 percent.[9] Additionally, SBA charges lenders an ongoing guarantee fee that is equal to 0.55 percent of the unpaid balance of the guaranteed portion of the loan.[10] In previous years, the program has relied on a subsidy from Congress to operate the program. However, because the fees have been sufficient, the program has been running on a zero subsidy cost to the American taxpayer for the last five fiscal years, including FY 2018.[11]

III. Program Participants

A. Small Businesses

To participate in the 7(a) Loan Program, small businesses must meet eligibility standards that consist of validating a need for capital, being a for-profit United States located enterprise, and being defined as a small business according to SBA's size standards.[12] Most importantly, a small business that wants to obtain a guarantee through the program must not be able to acquire capital from another source. The "Credit Elsewhere Test"[13] requires lenders to verify that a small business is not able to receive credit on reasonable terms from non-federal sources.[14] The

[6] SOP 50 10 5(J). Subpart B., Ch. 3(I).
[7] *Id.* at (II).
[8] For any government loan program, FCRA requires an agency to collect an appropriation or fee to cover the cost of the program. For the 7(a) Loan Program, SBA charges lenders guarantee fees depending upon the loan amount. 2 U.S.C. § 661.
[9] 15 U.S.C. § 636(a)(18)(A).
[10] *Id.* at § 636(a)(23).
[11] For FY 2014, SBA requested zero subsidy. SBA, FY 2014 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2012 ANNUAL PERFORMANCE REPORT 36. For FY 2015, SBA requested zero subsidy. SBA, FY 2015 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2013 ANNUAL PERFORMANCE REPORT 35. For FY 2016, SBA requested zero subsidy. SBA, FY 2016 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2014 ANNUAL PERFORMANCE REPORT 39. For FY 2017, SBA requested zero subsidy. SBA, FY 2017 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2015 ANNUAL PERFORMANCE REPORT 37. For FY 2018, SBA requested zero subsidy. SBA, FY 2018 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2016 ANNUAL PERFORMANCE REPORT 28.
[12] Under the Small Business Act, a small business is one that is independently owned and operated and not dominant in its field. 15 U.S.C. § 632(a)(1). In addition, the SBA is authorized to and does establish detailed size standards by industry to determine whether a business is small. *Id.* at § 632(a)(2). Small business size standards are usually expressed in terms of the number of employees or average annual receipts and correspond to industries according to the North American Industrial Classification System. https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards/table-small-business-size-standards.
[13] 15 U.S.C. § 632(h).
[14] 13 C.F.R. § 120.101.

verification process includes requiring the lender to document actions it has taken to determine whether or not the small business can obtain credit elsewhere. At its core, the program works to provide resources to creditworthy small businesses when the traditional banker's window is closed. Once all conventional lending options are exhausted, the creditworthy small business owner has the ability to apply for a loan guaranteed through the SBA. The program was never meant to displace or compete with traditional lending options; rather, it is intended to help small businesses meet their credit needs when no other options are available.

B. Lenders

To participate in the 7(a) Loan Program as a lender, the institution must be supervised by a state or federal regulator, be able to evaluate, process and close loans, and have the ability to disburse loans for public consumption. An extensive application process is required by the SBA for lenders to join the program, where lenders submit numerous pieces of information and financial documents.[15] Lenders also must meet requirements outlined by the SBA that pertain to on-site visits and loan performance metrics.[16] It is important to note that within the 7(a) Loan Program, more experienced lenders and those comfortable with SBA's loan process can be designated to operate with delegated authority with the ability to expedite and streamline the lending process.

IV. SBA's Oversight Functions

Within SBA and under the Office of Capital Access,[17] the Office of Credit Risk Management (OCRM) is charged with overseeing SBA's lending programs.[18] Through a combination of monitoring and enforcement actions, OCRM ensures the lending partners that are interacting with the nation's small businesses are operating in a prudent manner.

With regard to monitoring, OCRM concentrates on numerous areas including portfolio performance, credit quality, compliance with loan program requirements and risk metrics.[19] It is important to note that not all monitoring of a lending partner is the same. SBA determines its level of engagement based on the risk profile of the lender with large dollar lenders subject to heightened observation.[20] SBA also utilizes on-site and off-site reviews to obtain the critical oversight information of their lenders.

When it comes to enforcement actions, SBA has a responsibility to hold bad actors accountable for their actions. SBA uses its discretion to determine the level of enforcement but generally defines enforcement actions as either informal or formal. Informal enforcement actions include: supervisory letters; meetings; agreements not to sell loans into Secondary

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[15] SOP 50-10 5(J). Subpart A., Ch. 1(II)(C).
[16] 13 C.F.R. § 120.410.
[17] GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES 7 (GAO-15-347) (2015).
[18] "The Office of Credit Risk Management's mission is to maximize the efficiency of SBA's lending programs by effectively managing program credit risk, monitoring lender performance, and enforcing lending program requirements." https://www.sba.gov/offices/headquarters/ocrm.
[19] SOP 50-53 (A). Ch. 2(2)(b).
[20] *Id.* at Ch. 2(2)(a).

Market, etc.[21] When more serious situations arise, formal enforcement actions are required by SBA. They can include the following measures: suspension or revocation of delegated authority or suspension or revocation from SBA programs, etc.[22] Through a combination of both OCRM and the Lender Oversight Committee,[23] which votes on OCRM enforcement recommendations, corrective steps can be taken by SBA to mitigate problems in the lending community. Like many risk-based situations, a government guarantee program is only as strong as its oversight defense.

Over the years, efforts have been made by SBA to strengthen lender oversight functions. For example, in 2013, SBA created lender profiles and modernized its lender risk models.[24] Further, in 2014, SBA strengthened its oversight and verification of a lender's corrective action plans.[25] Then in 2016, SBA created performance measurements and risk mitigation benchmarks.[26] While improvements have been made, challenges still remain. SBA's Office of Inspector General (OIG) has listed "loan program risk management and oversight"[27] and continued trouble with quality control at loan centers as topics of concern.[28] Moreover, in its 2016 Audit Report, OIG raised issues with SBA's lender oversight protocols by highlighting deficient loan agent performance metrics.[29] Separately, the Government Accountability Office (GAO) has offered recommendations to the SBA regarding lender oversight and even categorizes lender oversight as one of SBA's "long-standing management challenges."[30]

V. Growth of the 7(a) Loan Program

In recent years, the 7(a) Loan Program has witnessed rapid growth. In FY 2012, the program approved $15.2 billion in loans,[31] while FY 2017 saw the program approve $25.4 billion in loans.[32] As loan approvals continue to climb, the 7(a) Loan Program has also continuously reached its authorized lending authority limit. The lending authority limit sets a maximum level for the amount of lending that can be administered through the 7(a) Loan Program. The lending cap was most recently reached during FY 2015, when the program was set at $18.75 billion. Through the *Veterans Entrepreneurship Act of 2015*, Congress raised the limit[33] and subsequently required more detailed lending authority statistics in order to inform

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[21] *Id.* at (4)(a).
[22] *Id.* at (b).
[23] *Id.* at Ch. 2(5)(v).
[24] SBA, OFFICE OF INSPECTOR GENERAL, REPORT ON THE MOST SERIOUS MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE SMALL BUSINESS ADMINISTRATION IN FISCAL YEAR 2015 (2014) at 5.
[25] *Id.*
[26] SBA, OFFICE OF INSPECTOR GENERAL, REPORT ON THE MOST SERIOUS MANAGEMENT AND PERFORMANCE CHALLENGES FACING THE SMALL BUSINESS ADMINISTRATION IN FISCAL YEAR 2017 (2016) at 9.
[27] *Id.* at 8.
[28] *Id.* at 14.
[29] SBA, OFFICE OF INSPECTOR GENERAL, AUDIT REPORT, SBA NEEDS TO IMPROVE ITS OVERSIGHT OF LOAN AGENTS 6 (2015).
[30] GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES 14 (GAO-15-347) (2015).
[31] SBA, FY 2018 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2016 ANNUAL PERFORMANCE REPORT 27.
[32] SBA, SBA LENDING ACTIVITY IN FY17 SHOWS CONSISTENT GROWTH (2017), *available at* https://www.sba.gov/about-sba/sba-newsroom/press-releases-media-advisories/sba-lending-activity-fy17-shows-consistent-growth.
[33] Veterans Entrepreneurship Act of 2015 § 4(a).

Congress on the limit being realized.[34] The FY 2017 lending authorization was set to support up to $26.5 billion in lending.[35] However, recent legislation that passed the House of Representatives and the Senate and signed by the President revised the cap upward to $27.5 billion in lending.[36] Due to multiple continuing resolutions, the cap stands at $27.5 billion.

VI. 7(a) Loan Program Improvements

In an effort to ensure the integrity of the 7(a) Loan Program for small businesses that truly require SBA's capital access resources, House Small Business Committee Chairman Steve Chabot (R-OH) and Ranking Member Nydia Velázquez (D-NY), along with Senate leaders, introduced H.R. 4743, the "Small Business 7(a) Lending Oversight Reform Act of 2018."[37] With the aim of increasing SBA's oversight functions, H.R. 4743 proposes a number of reforms to safeguard the program from lender abuse, while providing certainty to small businesses as they face an uncertain lending environment.

A. Increased Oversight

To increase SBA's oversight responsibilities, H.R 4743 codifies the Office of Credit Risk Management in the Small Business Act[38] to emphasize its lender supervision authority at SBA. The codification also outlines the duties of OCRM and its director, including that the director must be a career Senior Executive Service appointee. Additionally, to provide checks and balances on OCRM, the bill codifies the Lender Oversight Committee, its responsibilities and its membership requirements.

Although SBA has a number of enforcement actions available at its disposal, it lacks the ability to penalize a lender who severely ran afoul of rules and regulations with a civil monetary penalty. To this end, H.R. 4743 adds another tool in SBA's enforcement tool box by providing authority to implement a civil monetary penalty of no more than $250,000 on a lender.

Additionally, to strengthen the lender review process that SBA conducts, H.R. 4743 requires that an SBA employee supervises all onsite and offsite lender reviews. Historically, SBA has used a mix of contractors to perform this vital oversight task. Moreover, SBA is required to send an onsite review report to a lender in a timely manner, to ensure that if a corrective action is required, it can be performed quickly to limit a small business' exposure to a lenders wrongdoing.

Furthermore, H.R. 4743 requires SBA to conduct a comprehensive portfolio risk analysis of 7(a) lenders on an annual basis. Once the analysis is completed, SBA would be required to send it to Congress for review. The analysis is required to include, but not limited to, the program risk by industry concentration and risk created by the top one percent of 7(a) lenders by dollar value of loans and number of loans made. When a government guarantee program is utilized, a complete and clear picture of risk is required to safeguard the program.

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[34] *Id.* (c).
[35] Continuing Appropriations and Military Construction, Veterans Affairs, and Related Agencies Appropriations Act, 2017, and Zika Response and Preparedness Act, Pub. L. No. 114-223, 130 Stat. 857 (2016).
[36] Consolidated Appropriations Act, Pub. L. No. 115-31 (2017).
[37] H.R. 4743, 115th Cong. (2018).
[38] 15 U.S.C. §§ 631 – 57s.

It is important to note the increased oversight responsibilities will not require additional appropriations, as SBA has full authority outlined in the Small Business Act[39] and in the Code of Federal Regulations[40] to utilize lender fees to administer additional oversight. However, to increase transparency in SBA's oversight budget, H.R. 4743 institutes an internal budget submission process to ensure SBA properly allocates funds.

B. Credit Elsewhere and Additional Reforms

Acting as the gatekeeper of the 7(a) Loan Program, as described above, the Credit Elsewhere Test determines if a small business is eligible to receive a federal government guarantee. To update and modernize this foundational test, H.R. 4743 clarifies factors utilized in the process including consideration of the industry and the availability of collateral. Over the years, the test problematically shifted focus from a borrower's needs to a lender's capacity to operate within the program. The bill realigns the test to ensure it is based on a borrower's ability to obtain credit, rather than a lender's ability to offer credit. Strengthening of the Credit Elsewhere Test will guard the program for use by small businesses that justly require SBA's assistance.

Currently, the 7(a) authorized lending limit is set through the Congressional appropriations process. H.R. 4743 continues this practice, but provides flexibility to limit artificial runs on the program that puts small business lending in jeopardy. Specifically, the legislation provides the SBA Administrator the flexibility to notify and request approval by Congress to increase the limit once per fiscal year when the program nears its limit. In the past, when the program came close to its cap, an artificial run occurred because of the fear of a programmatic shutdown. A flexible option will reinforce organic and true growth, prevent small business lending uncertainty, and further prevent American taxpayer exposure.

Additionally, H.R. 4743 also requires a disclosure process for any waiver to a SBA lending program regulation. The disclosure provision requires a compilation of all Capital Access waivers in the Federal Register on an annual basis. To gain a better understanding of waivers to SOPs and policy notices, the legislation requires a Government Accountability Office study. Full transparency is needed for any government guarantee program.

VII. Conclusion

With a challenging lending environment continuing to provide hardships for small businesses, entrepreneurs, and startups, programs like SBA's 7(a) Loan Program are instrumental for communities and neighborhoods across the nation. However, with a government guarantee in play, robust oversight is needed to safeguard the program. H.R. 4743, the Small Business 7(a) Lending Oversight Reform Act of 2018, proposes changes to ensure stability for small businesses, while also protecting American taxpayer dollars.

[39] 15 U.S.C. § 634(b)(14).
[40] 13 C.F.R. § 120.1070 (2017).