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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 20515–0315

Memorandum

To:	Members, Committee on Small Business
From:	Committee Staff
Date:	April 16, 2018
Re:	Hearing: "An Examination of the Small Business Administration's 7(a) Loans to Poultry Farmers"

On Wednesday, April 18 at 11:00 am, the Committee on Small Business will hold a hearing titled, "An Examination of the Small Business Administration's 7(a) Loans to Poultry Farmers." The purpose of the hearing is for the Small Business Administration (SBA) Office of Inspector General (OIG) to present the results of its recent evaluation[1] of the SBA's 7(a) loans to poultry farmers. Members will also have an opportunity to hear how SBA intends to implement the OIG's recommendations to ensure future 7(a) loans meet the statutory, regulatory, and SBA requirements for eligibility.

I. 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[2] and the guarantee percentage ranges from 75 to 85 percent based on the loan amount.[3]

The SBA charges lenders an up front fee to run the loan program and to cover any losses to protect the American taxpayer in accordance to the 1990 Federal Credit Reform Act (FCRA).[4] While varying depending on loan size, the maximum fee is capped at 3.75 percent.[5] 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.[6] In previous years, the program has relied

[1] OIG, SBA, EVALUATION REPORT ON SBA 7(A) LOANS MADE TO POULTRY FARMERS, (Rep. No. 18-13) (2018), *available at* https://www.sba.gov/sites/default/files/oig/SBA-OIG-Report-18-13_0.pdf [hereinafter "IG Report"].
[2] SOP 50 10 5(J). Subpart B., Ch. 3(I).
[3] *Id.* at (II).
[4] 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.
[5] 15 U.S.C. § 636(a)(18)(A).
[6] *Id.* at § 636(a)(23).

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.[7]

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) introduced H.R. 4743, the "Small Business 7(a) Lending Oversight Reform Act of 2018."[8] Senators James Risch (R-ID) and Jeanne Shaheen (D-NH) likewise introduced the companion legislation, S. 2283, at the same time. 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. These bills both unanimously passed through both the House and Senate Committees on Small Business in March of 2018.[9]

II. Summary of OIG Evaluation, Findings, and Recommendations

A. Background

In the United States, the majority of chickens bred for meat production are broilers raised by poultry farmers (growers) under exclusive contracts with large chicken companies (integrators). The market value of the broiler industry was $25.9 billion as of 2016.[10] The industry's structure is largely controlled by the integrators who own and operate the hatcheries and deliver chicks to growers. Growers own the broiler housing and are responsible for raising the chicks until the flock is ready for market, generally a 5-9 week process.

Although growers make substantial investments to construct and operate their broiler houses, the true economic value of the grower's facility is the contract. As of 2016, the majority of contracts issued were for less than one year: 42 percent of growers only were contracted on a "flock to flock" basis while an additional 11 percent of contracts were for less than one year.[11] The market for growers is also highly concentrated: 57 percent of broiler production occurs in localities where there are only one or two integrators offering contracts to growers.

Growers can finance their facilities through commercial loans or the Farm Credit System; however, growers also use federally guaranteed loans offered by the United States Department of Agriculture (USDA) Farm Service Agency and SBA's 7(a) loan program. From fiscal year 2012

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[7] 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.
[8] H.R. 4743, 115th Cong. (2018).
[9] H.R. 4743, 115th Cong. (2018); S. 2283, 115th Cong. (2018). *See also* https://smallbusiness.house.gov/news/documentsingle.aspx?DocumentID=400726.
[10] IG Report, *supra* note 1, at 1.
[11] IG Report, *supra* note 1, at 2.

to 2016, the share of SBA poultry loans approved by lenders under delegated authority grew from 11 to 69 percent.[12] In the same time period, the share of the approved loans with maturity periods of more than 20 years increased from two percent to 57 percent.[13] The total value of the loans also increased dramatically, from $159 million in FY2012 to $534 million in FY 2016 (235 percent).[14] The average size of each loan increased by 91 percent (from $0.741 million to $1.4 million) during the same time period. The value of the approved loans reported as sold on the secondary market[15] increased as well during this period.[16]

B. OIG Evaluation

OIG reviewed Federal laws and regulations and SBA policies and procedures as well as loan files, contracts, and other documents and communications between integrators and growers. OIG also interviewed SBA and USDA officials, lenders, assessors, integrators, and growers. OIG analyzed the population of 7(a) agricultural loans (including those to poultry growers) among SBA's FY2012-FY2016 loan portfolio and selected a sample of 11 loans for more intensive review and analysis.[17] OIG's evaluation also included defaulted loans.

C. OIG Findings

OIG found that the 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility: integrators exercised such control over the growers through contracts, operating procedures, and other mandates that growers ceased to be independent businesses and became affiliates of the integrators. Under current SBA size standard regulations and requirements, large companies are not eligible for SBA loans.

OIG's review found that integrators mandated and supervised the design and building of grower facilities and performed rigorous oversight once the facility was operating. Integrators often mandated significant capital upgrades to grower facilities, requiring growers to seek additional funding from SBA.

Failure to comply with integrator requirements could (and did) result in adverse actions and ultimately affected the value of the contract. Integrators decreased payments, reduced flock placements, withheld flocks, or cancelled contracts—actions that resulted in changes to a grower's income and the true value of the business. The most severe actions—withholding chicks or terminating contracts—resulted in the businesses failing. Without an integrator contract, grower facilities have little value and are deemed "worthless" by appraisers and lenders.[18] Facilities without contracts were liquidated and sold for up to 94 percent below the original appraised value (with a contract).

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[12] IG Report, *supra* note 1, at 3.
[13] *Id*.
[14] IG Report, *supra* note 1, at 4.
[15] The act of selling all or portions of a 7(a) loan on the secondary market is authorized under 13 C.F.R. § 120.601.
[16] IG Report, *supra* note 1, at 5.
[17] IG Report, *supra* note 1, at 11.
[18] IG Report, *supra* note 1, at 8.

OIG determined that SBA failed for years to recognize that growers had become affiliates of integrators who were ineligible for 7(a) loans. SBA relied on a 1993 Agency decision to continue to allow these loans.[19] SBA was not able to produce the contract that was the basis of the decision and the actual terms of the contract are unknown. SBA admitted to OIG that there has been no subsequent determination on affiliation in regard to the 7(a) program and that a 2016 regulatory change made the 1993 decision immaterial. OIG also found that SBA, unlike USDA, does not employ staff with knowledge of the poultry industry and thus relied on lenders to properly underwrite the loans.

Given the evidence of affiliation, OIG found that from FY2012 to FY2016, SBA guaranteed approximately $1.8 billion of 7(a) loans that may be ineligible.[20]

D. OIG Recommendations

OIG recommends that SBA review the 11 loans in the sample to determine whether SBA and lenders made a proper size determination given the affiliation and take appropriate corrective action.

Additionally, OIG recommended that SBA review the arrangements between integrators and growers and establish additional controls to ensure that SBA and lenders make appropriate affiliation determinations in the future.[21]

III. Conclusion

The mission of the SBA is to help small businesses succeed. As part of that mission, SBA helps small businesses access capital by guaranteeing loans through the 7(a) program. OIG's findings indicate that the loans to poultry farmers benefited large companies while often placing small businesses in jeopardy and unable to operate their businesses independently. In order to ensure that taxpayer dollars are preserved for America's small businesses that may not be able to obtain capital elsewhere, this hearing will provide an opportunity to hear from SBA about corrective actions as well as how H.R. 4743[22] will require additional oversight of the lenders and provide additional program integrity.

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[19] IG Report, *supra* note 1, at 9.
[20] *Id*.
[21] IG Report, *supra* note 1, at 10.
[22] H.R. 4743, 115th Cong. (2018).