

**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: Committee Staff  
Date: May 15, 2017  
Re: Hearing: "SBA's 7(a) Loan Program: A Detailed Review"

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On Wednesday, May 17, 2017 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. As a way to review the program's ability to help creditworthy small businesses obtain capital, this hearing will offer Members of the Committee the opportunity to hear from SBA officials directly involved in administering the program.

## **I. Introduction**

While large companies regularly raise capital through debt and equity markets, small businesses often finance their endeavors with personal assets or commercial bank borrowing. Unfortunately, the lending environment around the country for small businesses continues to be stagnant. According to research compiled by the Federal Reserve Bank of St. Louis, the total value of loans by small domestic banks has remained flat since the recession and depressed as compared to levels before the recession.<sup>1</sup> With capital options reduced, small businesses turn to the SBA to finance their projects. The SBA, which was created in 1953 by the Small Business Act, administers several programs designed to assist small businesses, including capital access programs that aim to bridge the debt and equity gaps that exist in the marketplace.

## **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. Named after § 7(a) of the Small Business Act,<sup>2</sup> the program is SBA's flagship lending option for creditworthy small firms that cannot obtain sufficient capital from conventional lending.<sup>3</sup> 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<sup>4</sup> and the guarantee percentage ranges from 75 to 85

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<sup>1</sup> <https://fred.stlouisfed.org/series/EVAXSSNO>.

<sup>2</sup> 15 U.S.C. §§ 632-57s.

<sup>3</sup> SOP 50 10 5(I), Subpart A., Ch. 1(I).

<sup>4</sup> *Id.* at Subpart B., Ch. 3(I).

percent based on the loan amount.<sup>5</sup> The interest rate charged to small businesses has an inverse relationship with the size of the loan whereby the smallest loans have the highest rate.

Authorized in the 1974 Small Business Amendments,<sup>6</sup> 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).<sup>7</sup> While varying depending on loan size, the maximum fee is capped at 3.75 percent.<sup>8</sup> 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.<sup>9</sup> 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 four fiscal years, including FY 2017.<sup>10</sup>

### 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.<sup>11</sup> Most importantly, a small business that wants to obtain a guarantee through the program must not be able to acquire capital from another source. Outlined in a SBA standard operating procedure (SOP), the "credit elsewhere test"<sup>12</sup> requires lenders to verify that a small business is not able to receive credit on reasonable terms from non-federal sources.<sup>13</sup> The verification process includes requiring the lender to document actions it has taken to determine whether or not the small business can obtain credit elsewhere.<sup>14</sup> To further strengthen the credit elsewhere test and to protect the American taxpayer, Congress, among other things, altered the test's definition in the *Veterans Entrepreneurship Act of 2015* by prohibiting a lender from relying solely on its own liquidity from selling the guarantee on the secondary market to satisfy the credit elsewhere test.<sup>15</sup>

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<sup>5</sup> *Id.* at (II).

<sup>6</sup> Pub. L. No. 93-386 (1974).

<sup>7</sup> 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.

<sup>8</sup> 15 U.S.C. § 636(a)(18)(A).

<sup>9</sup> *Id.* at § 636(a)(23).

<sup>10</sup> 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, the subsidy equals zero. SBA, FY 2017 CONGRESSIONAL BUDGET JUSTIFICATION AND FY 2015 ANNUAL PERFORMANCE REPORT 37.

<sup>11</sup> 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>.

<sup>12</sup> SOP 50 10 5(I). Subpart B., Ch. 2(III)(C)(1).

<sup>13</sup> 13 C.F.R. § 120.101.

<sup>14</sup> SOP 50 10 5(I). Subpart B., Ch. 2(III)(C)(3).

<sup>15</sup> Pub. L. No. 114-38, 129 Stat. 437 (July 28, 2015).

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. While lengthy, and at times laborious, the 7(a) Loan Program application process is designed to be thorough. It requires the submittal of numerous forms delving into the fitness of the endeavor.<sup>16</sup> The program was never meant to displace or compete with traditional lending options; rather, it was 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 information ranging from name and address to audited financial statements.<sup>17</sup> Lenders also must meet requirements outlined by the SBA that pertain to on-site visits and loan performance metrics.<sup>18</sup>

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 within the boundaries of the Certified Lenders Program (CLP)<sup>19</sup> or the Preferred Lenders Program (PLP).<sup>20</sup> Both programs expedite and streamline the process, while still meeting SBA requirements. Specifically, lenders in the CLP program are given an enhanced level of authority and thus are able to move through the application process quickly from start to finish. However, in the PLP program, lenders are granted the highest level of delegated authority and can provide guarantees without SBA's participation in the loan review process.<sup>21</sup>

### IV. SBA's Oversight Functions

Within SBA and under the Office of Capital Access,<sup>22</sup> the Office of Credit Risk Management (OCRM) is charged with overseeing SBA's lending programs.<sup>23</sup> 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 proper manner.

With regard to monitoring, OCRM concentrates on numerous areas including portfolio performance, credit quality, compliance with loan program requirements, financial health, and

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<sup>16</sup> <https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/small-business-loans-sba-advantage-loans-7a/loan-application-checklist>.

<sup>17</sup> SOP 50-10 5(I). Subpart A., Ch. 1(II)(c)(2)(b).

<sup>18</sup> 13 C.F.R. § 120.410.

<sup>19</sup> 13 C.F.R. § 120.440.

<sup>20</sup> 13 C.F.R. § 120.450.

<sup>21</sup> SOP 50-10 5(I). Subpart A., Ch. 1(IV)(A).

<sup>22</sup> GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES (GAO-15-347) (2015) at 7.

<sup>23</sup> "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>.

risk metrics.<sup>24</sup> 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.<sup>25</sup> SBA also utilizes on-site and off-site reviews to obtain the critical oversight information of their lenders. Although not exhaustive, the following reports are required by SBA to conduct many of these reviews: monthly loan payment reports and annual and quarterly financial condition reports.<sup>26</sup> All combined, this monitoring is set up to ensure lenders are meeting the requirements of the 7(a) Loan Program.

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 Market, etc.<sup>27</sup> When more serious situations arise, formal enforcement actions are required by SBA. They can include the following measures: suspension or revocation of delegated authority, suspension or revocation from SBA programs, etc.<sup>28</sup> Through a combination of both OCRM and the Lender Oversight Committee,<sup>29</sup> corrective actions 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.<sup>30</sup> Further, in 2014, SBA strengthened its oversight and verification of a lender's corrective action plans.<sup>31</sup> Then in 2016, SBA created performance measurements and risk mitigation benchmarks.<sup>32</sup> While improvements have been made, challenges still remain. SBA's Office of Inspector General (OIG) has listed "loan program risk management and oversight"<sup>33</sup> and continued trouble with quality control at loan centers as topics of concern.<sup>34</sup> Moreover, in its 2016 Audit Report, OIG raised issues with SBA's lender oversight protocols by highlighting deficient loan agent performance metrics.<sup>35</sup>

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."<sup>36</sup> Specifically, GAO recommended that the SBA sharpen its focus on its lending programs and strengthen its "risk management of the 7(a)

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<sup>24</sup> SOP 50-53 (A). Ch. 2(2)(b).

<sup>25</sup> *Id.* at Ch. 2(2)(a).

<sup>26</sup> *Id.* at Ch. 2(3)(a).

<sup>27</sup> *Id.* at Ch. 2(4)(a).

<sup>28</sup> *Id.* at Ch. 2(4)(b).

<sup>29</sup> *Id.* at Ch. 2(5)(v).

<sup>30</sup> 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.

<sup>31</sup> *Id.*

<sup>32</sup> 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.

<sup>33</sup> *Id.* at 8.

<sup>34</sup> *Id.* at 14.

<sup>35</sup> SBA, OFFICE OF INSPECTOR GENERAL, AUDIT REPORT, SBA NEEDS TO IMPROVE ITS OVERSIGHT OF LOAN AGENTS (2015) at 6.

<sup>36</sup> GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES (GAO-15-347) (2015) at 15.

program.”<sup>37</sup> Because American taxpayer funds are at risk, OCRM must have the measures in place to respond to any financial lending situation.

## V. Growth of the 7(a) Loan Program

As the economy experienced a downturn during the financial crisis, and while most Americans are experiencing an improved economy,<sup>38</sup> 7(a) loan approvals have generally recorded positive year-over-year growth. Specifically, since the start of the economic crisis in 2007 and 2008<sup>39</sup> when financial markets were roiled across the globe and systemic risk engulfed lending institutions, loan approvals for the 7(a) Loan Program had only three down years (FY 2008, FY 2009 and FY 2012) – all other years experienced year-over-year growth.<sup>40</sup> This includes FY 2016, a record year according to SBA.<sup>41</sup> Specifically, SBA’s Agency Financial Report for FY 2016 highlighted that “the 7(a) program showed impressive gains in comparison to FY 2015, with over 64,000 loans totaling \$24.1 billion — an increase of 2 percent in number of loans and 2 percent in total dollars.”<sup>42</sup>

As loan approvals continue to climb, the 7(a) Loan Program has also continuously reached its authorized lending authority limit. The lending authority limit, which is determined by Congress, 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<sup>43</sup> and subsequently required more detailed lending authority statistics in order to inform Congress on the limit being realized.<sup>44</sup> The FY 2017 lending authorization was set to support up to \$26.5 billion in lending.<sup>45</sup> 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.<sup>46</sup>

## VI. Conclusion

With over 29 million small businesses in the United States and roughly half of all private sector employees working for a small business, small firms are the backbone of the American economy.<sup>47</sup> When small businesses succeed, so does the economy. However, access to capital continues to remain a top concern for small businesses. With the continued growth of the 7(a) Loan Program, it is imperative the program runs efficiently and ensures taxpayer’s dollars are protected. Although improvements have been made to its oversight functions in recent years,

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<sup>37</sup> *Id.* at 105.

<sup>38</sup> <https://data.bls.gov/timeseries/LNS14000000>.

<sup>39</sup> Federal Reserve Bank of St. Louis, *The Financial Crisis, Full Timeline*, available at <https://www.stlouisfed.org/financial-crisis/full-timeline>.

<sup>40</sup> [https://www.sba.gov/sites/default/files/WDS\\_Table3\\_ApprovalCount\\_Report.pdf](https://www.sba.gov/sites/default/files/WDS_Table3_ApprovalCount_Report.pdf).

<sup>41</sup> SBA, AGENCY FINANCIAL REPORT FISCAL YEAR 2016 at 7 (2016).

<sup>42</sup> *Id.* at 4.

<sup>43</sup> *Veterans Entrepreneurship Act of 2015* § 4(a).

<sup>44</sup> *Id.* (c).

<sup>45</sup> 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. (Sept. 29, 2016).

<sup>46</sup> Consolidated Appropriations Act, 2017, Pub. L. No. 115-31 (2017).

<sup>47</sup> SBA OFFICE OF ADVOCACY, SMALL BUSINESS PROFILE (2017), available at [https://www.sba.gov/sites/default/files/advocacy/United\\_States\\_1.pdf](https://www.sba.gov/sites/default/files/advocacy/United_States_1.pdf).

SBA must recognize its shortfalls and develop a plan for further improvements, particularly as the number of loan approvals continues to grow. Oversight must be comprehensive, ongoing, and deliberative. Anything less leaves the 7(a) Loan Program vulnerable to fraud and abuse. The Committee is dedicated to ensuring the program addresses the credit gap for creditworthy small businesses that cannot obtain capital through conventional means while working on behalf of the American taxpayer.