VETERANS SMALL BUSINESS LOANS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND MEMORIAL AFFAIRS
OF THE

COMMITTEE ON VETERANS' AFFAIRS
HOUSE OF REPRESENTATIVES

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CONTENTS

May 13, 1993

	Page
Veterans Small Business Loans	1

OPENING STATEMENTS

Chairman Sangmeister	1
Prepared statement Chairman Sangmeister	35
Hon. Dan Burton	54

WITNESSES

Cox, John, Director, Office of Financing, Small Business Administration	18
Prepared statement of Mr. Cox	83
Crandell, William F., legislative advocate, Vietnam Veterans of America, accompanied by Paul S. Egan, executive director	27
Prepared statement of Mr. Crandell	92
Dupree, Clifton E., associate legislative director, Paralyzed Veterans of America	25
Prepared statement of Mr. Dupree	87
Dwyer, Donald, Veterans Transition Franchise Initiative	28
Prepared statement of Mr. Dwyer	97
Magill, James N., legislative director, Veterans of Foreign Wars	26
Prepared statement of Mr. Magill	90
Pedigo, Keith, Director, Loan Guaranty Service, Department of Veterans Affairs, accompanied by James Kane, Assistant General Counsel	16
Prepared statement of Mr. Pedigo	78
Rohde, Steve, Hansen, McOuat, Hamrin & Rohde	6
Prepared statement of Mr. Rohde	62
Terrell, Frederick O., managing director, First Boston Corporation	2
Prepared statement of Mr. Terrell	56

MATERIAL SUBMITTED FOR THE RECORD

Statements:	
Disabled American Veterans	107
The American Legion	109
Puerto Rican Veteran's Association of Mass, Inc.	113
Non Commissioned Officers Association	114
AMVETS	117
Written committee questions and their responses:	
Chairman Sangmeister to Department of Veterans Affairs	120
Congressman Burton to Department of Veterans Affairs	120
Chairman Sangmeister to Small Business Administration	122
Congressman Burton to Small Business Administration	122

VETERANS SMALL BUSINESS LOANS

THURSDAY, MAY 13, 1993

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS,
COMMITTEE ON VETERANS' AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, 9:39 a.m., in room 334, Cannon House Office Building, Hon. George E. Sangmeister (chairman of the subcommittee) residing.

Present: Representatives Sangmeister, Bishop and Spence.

OPENING STATEMENT OF CHAIRMAN SANGMEISTER

Mr. SANGMEISTER. Good morning. Members will be coming and going. It is obviously one of those days again. I was also informed that we are now going to be in session at 10 o'clock this morning. So we are going to have to work around any recorded vote calls that may come at that time.

The subcommittee will come to order. I am pleased to welcome all of our witnesses to explore and discuss a small business loan program for veterans.

I look forward to hearing the views of the VA, the SBA, financial institutions and, of course, the veterans' organizations.

While the Department of Veterans Affairs had a direct loan program authorized by Public Law 97-72, funds were never appropriated, and no loans were ever made or guaranteed. It is my understanding that the SBA actually administered a small business loan program specifically for veterans from existing appropriated funds.

Yet the subcommittee has never heard from the veterans and the service organizations expressing the view that the veterans are not adequately served in their efforts to obtain loans to start small businesses. I am hopeful that from this hearing, the subcommittee will gain insight into this perception. Simply, what we want to know, is this fact or is it fiction.

A review of VA and SBA statistics indicates that the average SBA loan is for $242,000, and only 11 percent of the SBA loans are under $100,000. Let me emphasize that the draft proposal today seeks to target veterans that desire loans under $100,000. One could argue that these very loan accounts are currently underserved by the SBA.

Such numbers are disturbing when one considers that veterans comprise 20 percent of the small business population, and yet they receive less than 14 percent of the SBA loans. Providing more loans under $100,000 to veterans, whether by VA under the pro-

posed bill or under existing SBA programs, could lessen this discrepancy.

Under the draft legislation, and I emphasize this is only draft legislation, the maximum loan amount would be $100,000, with a VA-backed guarantee of 50 percent. Fifty-one percent of the small business concern must be owned by eligible veterans.

The VA's preliminary cost estimates illustrate that the 4 percent collected in fees would recover losses as a result of any estimated loan defaults.

The testimony received today will help us determine the advantages and the disadvantages of implementing a new small business loan program for veterans or whether it is best to proceed by better targeting and increasing the number of veterans served by the existing SBA program.

Before we call up the first witnesses, Mr. Burton, who is the Ranking Member on the Republican side, was unable to be here and by way of unanimous consent we will make his remarks a part of the record.

[The statement of the Hon. Dan Burton appears on p. 54.]

Mr. SANGMEISTER. There was a press release issued last year by the VA in which the Acting Secretary at that time, Anthony J. Principi, indicated that this program will follow in the footsteps of the GI Bill home loan program of 45 years ago and will mark a new era toward meeting the needs of veterans who want to start their own businesses. Under this program, it will be easier for veterans to obtain loans, less red tape, lower interest rates, and less collateral. So we know that has not materialized in the way of legislation.

So we are pleased that we are able to have the witnesses we have here today who can help enlighten us on this, and in the first panel we have Mr. Frederick Terrell, Managing Director of the First Boston Corporation, and Mr. Steve Rohde, who is a principal in the consulting firm of Hansen McOuat, Hamrin & Rohde.

Okay. Gentlemen, thank you for being here today. I hope you can shed some light on this. I am sure the committee as a whole does not have their feet in concrete on this proposed legislation. We do not want duplicity. If SBA is doing what they should be doing, we need to know that. Perhaps testimony today will make our decisions on this legislation easier.

Mr. Terrell, we will start with you.

STATEMENT OF FREDERICK O. TERRELL, MANAGING DIRECTOR, FIRST BOSTON CORPORATION, AND STEVE ROHDE, HANSEN, MCOUAT, HAMRIN & ROHDE

STATEMENT OF FREDERICK O. TERRELL

Mr. TERRELL. Thank you, Mr. Chairman.

Mr. SANGMEISTER. Your written remarks will be made part of the record. You may proceed as you see fit.

[The prepared statement of Mr. Terrell appears on p. 56.]

Mr. TERRELL. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, thank you for the opportunity to share my thoughts on the Department of Veterans Affairs' contemplated small business loan program.

I am a Managing Director with the First Boston Corporation. I have been with the firm since 1983. First Boston, as you may know, is a full service, international investment banking firm serving both suppliers and users of capital around the world. In my current capacity, I serve as co-head of the firm's conventional issuance and trading group, which has responsibility for delivering mortgage and asset-related investment banking services to banks, thrifts, and Federal agencies, as well as other entities operating within the broad financial institutions area.

During the last several years, I have also had the responsibility of leading First Boston's Federal Government finance efforts as the firm has become actively involved with the Federal Government's program to liquidate certain assets from the balance sheets of its agencies and departments.

As an outgrowth of this effort, I am proud to say that First Boston currently serves as lead manager for the Department of Veterans Affairs' vendee loan securitization program through which the mortgage market's first full faith and credit REMIC securities were issued last year.

This committee had a substantial amount to do with the success and the progress of that program, which market participants, First Boston, is appreciative. I think it is a benchmark for programs in the secondary market. We have been very proud to be associated with it.

Among the wide variety of securitization efforts within the federal sector, the firm is also involved in the Small Business Administration's securitization programs. One on behalf of SBICs, or small business investment companies, and MESBICs, minority owned small business investment companies, and the other the Section 504 program on behalf of community development corporations or CDCs across the country.

Mr. Chairman, I am joined today by my colleague John Trusbury.

The comments that follow represent an analysis of the proposed VA program relative to small business lending programs which are already in place. Examining and understanding the existing programs, as you have mentioned, is one method of determining the need for an additional federal plan, and designing the plan if such a need exists.

As you are aware, the program which already exists and the one that is most similar to the one that is proposed today is the SBA's 7(a) program. The SBA's 7(a) program is a full faith and credit guarantee program just as the ones proposed. The major difference is that 90 percent of the loans are guaranteed by the Federal Government, whereas in the proposed VA program only 50 percent of the loans would be guaranteed.

I should also say that the SBA covers 90 percent of the portion of every loan under $155,000 and 80 percent of the portions between $155,000 and the maximum of $750,000. The average loan size is about $250,000.

The terms of the SBA program include a 2 percent fee imposed on the borrower, which would be typically subtracted from loan proceeds. The interest rates are either fixed or adjustable. Depend-

ing on the environment, you will see more fixed or adjustable product predominant.

The average interest rates on the 1992 adjustable rate loans averaged about 100 basis points above nonguaranteed loans. Just to put that in some context, small business loans would probably be at the level of 1½ or 2 points above prime. So you can tack on another 100 basis points or 1 percentage point above that to think of the loans that are a part of the SBA program.

The maturities of loans issued under the program tend to be quite long, three to four times as long relative to private bank, commercial and industrial loans, which I am going to call CNI loans. These extended maturities serve the purpose of keeping payments low, and this is critically important just because the small business person is obviously getting on his feet in many cases, and the idea is to keep the periodic payments as low as possible to make the program much more forgiving for the participants.

The role which is played by First Boston and other major market participants in the SBA program is the role of guaranteeing or I should say providing a secondary market for the guaranteed portions. I have provided an illustration to my right, of the SBA program and its guaranteed portion compared to the VA proposed program.

In the secondary market for the SBA program, what the market is actually playing in is the guaranteed component, the 90 percent portion. In this program they would be concerned with the 50 percent portion.

I would also say that if a VA program were to be launched, not only would you find secondary market participants trading actively the guaranteed portion, but I would say given the technology that exists in the mortgage market today and securitization market, market participants might also play in the first loss portion of it, as well, that bottom 50 percent.

Because if you assume losses only come up so high in that bottom 50 percent, the portion above that probably is better than the portion below. So at some point even that first loss position can be traded actively at a higher yield than the guaranteed portion, obviously, but still there is probably a secondary market for that.

But the point is combining the guaranteed portion in the secondary market with whatever you could carve off, could skim off the top of the first loss provision, the aggregate of that, the hybrid, would be higher than a guaranteed portion.

I mention all of this because one of our major concerns about the SBA program or I should say the proposed VA program versus the SBA program that is in place, is the role of the lender. Lenders have flocked to the SBA program because there is a 90 percent guaranteed portion and because the amount retained as first loss, as risk on the bank lender's balance sheet, is that 10 percent.

The idea of having a larger percentage, 50 percent, will be a problem for many lenders as they will view this program in the context of other borrowers as being a little bit more risky, and just a little bit more about that context. Obviously, the program has the best of intentions, which we wholeheartedly support. Imagine a returning vet who deserves our support successfully reenters the economic mainstream. That is an easy proposition to support.

However, until he or she is among that mainstream, to a lender who is looking at it quite dispassionately and objectively, they represent a riskier borrower compared to other lenders in the market.

In the SBA program, the lender knows that even though it's a small business borrower, only 10 percent is on their side of the fence, and the 90 percent is guaranteed. Obviously the issue will be much more sensitive to lenders when they know that the first loss up to 50 percent will be on their balance sheet.

So, therefore, we believe lenders will have less of an incentive to participate with the VA program than they do currently with the SBA program.

Moreover, we believe that veterans in search of government guaranteed small business loans could approach the SBA to get a larger loan at a lower rate with fewer points. So we believe that the SBA program as currently constructed is flexible enough to house interested participants who are veterans.

The SBA's $750,000 maximum balance might give borrowers a level of comfort that they will not outgrow the VA's program.

I would say, lastly, that the relatively small size of the securitized portion, the 50 percent of the proposed VA program, would lead to a smaller secondary market for the paper, even though I have said that participants in the secondary market may dip down below the guaranteed portion.

So our suggestions, as you can tell from where I am leading, are that we believe that there is a program in place already that is consistent with the goals that have been enunciated in the VA program, and given that Federal program is in place, we believe that it probably makes more sense from our perspective to work at successfully or more successfully linking the objectives contemplated under the VA strategy with what is already in place under the SBA program.

Instead of creating a duplicate infrastructure to cope with the issues of the guarantor, the Department of Veterans Affairs could establish a liaison who educates veterans about risk and rewards of business ownership and who brings business to the doors of willing lenders.

This program would promote the desired goals, we believe, within the existing framework. This would also be an immediate method of reaching deserving veterans and developing a primary and secondary market that could be very time consuming.

Moreover, the additional lending under the SBA 7(a) program would add liquidity to the program and make the secondary market even more efficient, rather than starting a program that stands on its own that may be viewed as secondary market participants being different and not as fungible with current SBA 7(a) program loans.

The VA in its role as liaison will be well suited for the process applications, it seems to us, and create standardized documentation on program eligibility and raise the awareness around the program. This conscious raising and additional revitalization of existing programs could help insure the consistency of funding for the program.

Recent setbacks suffered by the incumbent administration in providing funding for a program, as popular as small business lending,

could be offset by the power of an agency like the Department of Veterans Affairs.

A number of decisions will have to be made to assess political plausibility of such a proposal, and obviously that is not our business, but it would certainly seem to be a lower cost way to accomplish the same goals which we support.

With that said, I would just offer that the idea has a lot of merit. We have prided ourselves over time, Mr. Chairman, in providing a secondary market and some very complicated instruments which no one thought were very well suited for the market. So I have every confidence that First Boston, along with all of our colleagues, our brethren in the investment banking business, can work and provide a secondary market for the program if it is passed.

However, we think that a program that would facilitate the needs of veterans as borrowers already exists, and that is a program that is well underway and the secondary market exists already. So we think it probably makes as much sense to look at ways to enhance that program than starting another one, although we would be prepared to offer any assistance if such a program as the one proposed is passed.

With that said, I would be very happy to answer any questions you have. I thank you again for the opportunity to come before you.

Mr. SANGMEISTER. Well, we thank you for that testimony. For the record here, two of my colleagues have joined me, Mr. Bishop from Georgia and Mr. Spence from South Carolina.

I think before we have any questions we ought to hear the testimony of Mr. Rohde, and maybe we can address some of the same questions to both of you. Mr. Rohde, why don't you proceed.

STATEMENT OF STEVE ROHDE

Mr. ROHDE. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I am delighted to be here this morning. My consulting firm assists states, cities, Federal agencies, and other organizations in the development and implementation of innovative development and finance programs.

First, let me say that I think it is a good objective to attempt to develop new tools which could serve as a useful complement to the SBA loan guarantee program, especially for small loans of under $100,000. So I think that objective is a good objective.

However, in my judgment, there are serious questions as to whether the particular approach that was proposed last year by the Department of Veterans Affairs would, in practice, prove to be an effective approach.

As has been suggested, there would be a lower guarantee percentage. It is a loan-by-loan guarantee, and instead of guaranteeing up to 90 percent of a loan, as in the SBA program, the guarantee percentage would be lowered to 50 percent, and presumably that, in turn, would allow the program to be implemented in a less bureaucratic way, perhaps even delegating authority to the banks to make the loans without prior approval.

Certainly any program that is easier to implement and relies more on the banks for decisionmaking, does not review and second

guess banks' decisionmaking will be attractive to banks. On the other hand, using this loan-by-loan guarantee approach, there is an inherent tradeoff between making the program more attractive by making it less bureaucratic, by lowering the guarantee percentage and at the same time making the program less useful to banks as a vehicle to expand to some degree the risk they can take on loans, and that is, after all, what this is about, to give banks a tool to stretch themselves by taking more risk.

By lowering the guarantee percentage to 50 percent, that is going to make it a lot less useful as a tool to take more risk, and I would concur in that respect with the remarks that Mr. Terrell has made.

The effect of that would be that I fear that under this proposed program, it would sharply limit the number of loans that banks would actually make, or loans that they otherwise would not have done, which of course is the objective of the program also.

So I think the goal is a good one, but I think the structure of the program raises some serious questions. If the Congress wishes to consider a new approach that could serve as a useful complement to the SBA loan program, particularly for loans of less than $100,000, and do it in a very nonbureaucratic way, there is actually a model that was pioneered in the State of Michigan starting in 1986, has proved highly successful in Michigan, and is now being copied by a number of other states, and that program is called the Capital Access Program.

But I want to emphasize that what is unique about the Capital Access Program and what makes it a useful complement to the SBA is that it takes a different approach. It is not a loan-by-loan guarantee approach. Instead it is a portfolio insurance concept, and the way it works is that if a bank participates in the Capital Access Program, a special reserve account would be set up, separately earmarked for each bank participating in the program that would cover future losses on the whole portfolio of loans that the bank makes under the program.

Because of this special reserve account earmarked for a particular bank, it does give the bank incentive to take substantially more risk on their loans than they otherwise could take, but at the same time, it gives banks a strong, built-in incentive to manage that extra risk-taking that they are doing because they know that if the losses on the whole portfolio were to exceed the overall coverage provided by this special reserve account, then the bank is fully at risk for that excess.

So it is a tool to take more risk, but they have to manage that risk-taking, and there is a built-in incentive for prudence, and because of that built-in incentive for prudence, there is no need at all for the State of Michigan or any other public body that would be implementing these programs to review and second guess the bank's lending analysis.

In fact, the loan is made, and there is a one-page form to file with the state within ten days after the loan is made.

Now, the actual experience in Michigan since the program was launched in 1986 is that they are making a portfolio of loans that are riskier. In fact, my estimate is that the ultimate loss rate is running about four or five times a normal bank loss rate, but the key to understand is that is well within the limit of these reserve

accounts to cover, and in almost every case, if there has been a loss on the loan the full amount of that loss has been able to be recovered by the reserve account because there was enough in the reserve account to cover it.

Since 1986, Michigan banks have used this program to make loans to more than 2,000 companies. The average loan amount has been about $50,000. About 90 percent, almost 90 percent of the loans have been for less than $100,000, and the program has really been enthusiastically embraced by banks throughout Michigan.

If this program were to be implemented on a full-fledged national basis, one, I think, of the real attractive features of it is the Federal Government, through use of the full faith and credit guarantee concept as a way to support the reserve accounts instead of support them through cash as is done at the state level; if it is done through a full faith and credit guarantee, based on the experience in Michigan it is likely that this program, in effect, would pay for itself because experience in Michigan indicates that the fees collected from the private sector over a long period of time actually exceed the amounts paid out in claims, and the amounts paid out in claims are sharply limited roughly to about 5 percent of the total loan amounts, on average, because that is the amount of public support to these reserve accounts. So, in effect, it could be implemented at virtually no cost to the Federal Government.

The final point I wanted to make is that although I think this has a lot of potential as a useful complement to the SBA loan program and can be very useful for veterans, it can only really be useful to veterans if, in fact, it is implemented on a broad-based basis for both veterans and nonveterans alike. This is not a program that can be effectively limited to veterans, and the reason is because it is based on this portfolio insurance concept, and banks need to understand, need to have confidence that they will be able to build up a substantial portfolio of loans under this program within a reasonable amount of time, and any sharp limiting of the market would, in effect, make the program ineffective for banks.

So it can be very effective for veterans only if implemented on a broad-based manner.

Thank you very much, and I would be happy to answer any questions by any members of the committee. I also would like to submit for the record of the committee a detailed program description from the Michigan program, as well as current statistical data showing breakdowns by loan amount, industry breakdowns, and size of companies from the Michigan program.

Thank you.

Mr. SANGMEISTER. We have that material here, and without objection, it will be made a part of the record.

[The prepared statement of Mr. Rohde appears on p. 62.]

Mr. SANGMEISTER. Mr. Terrell, in hearing and reading your testimony, apparently you have three objections. I want to make sure I have that clear. That indicates to me that you are not supportive of a new veterans program since the loan guarantees of the SBA are 80 to 90 percent and the draft bill only guarantees 50 percent. That is going to be a big factor.

What you are saying is, why should a veteran, seek a loan under what would be our proposed legislation, when you can go to the SBA and do better now? Is that correct?

Mr. TERRELL. Yes, Mr. Chairman.

Mr. SANGMEISTER. It also means they could get a larger loan than what our draft legislation has, a lower rate with probably fewer points, and of course, the security of the loan, 50 percent of the $100,000 versus 90 percent.

So those are the three big items that would generate oppositions, if we passed this legislation in its present form. Is that what you are saying?

Mr. TERRELL. Well, yes, Mr. Chairman. I guess of the three my biggest criticism would be that from the lender's perspective, and it is a lender-driven business, to incentivize lenders to be involved in the program all together with small business loans in a smaller context, veterans loan, you have got to provide more guarantee, not less.

It seems to me that there would be fewer lenders participating in a program like this, and there is capacity in the SBA 7(a) program. So it is duplicative in that respect, and I think it would create a smaller market for an inferior security.

Mr. SANGMEISTER. I do not know how many of us completely understand the secondary market. That is another world you operate in, and how you package loans and move them around. From your testimony does this mean it would complicate the secondary market?

Mr. TERRELL. Mr. Chairman. I think that the secondary market is sophisticated enough to work with any loan that is out there and try to make a market out of it, to try to trade it with other people who are active in the market.

However, if the goal is to provide lower cost borrowing for the veteran, a program that has a 90 percent guarantee versus a program that has a 50 percent guarantee, one program is likely to be larger. More liquidity is going to mean lower rates over time, and it would be seen as a separate program.

Whereas if it were blended together, the veterans would enjoy the benefits of a larger, more liquid program that has a lower financing rate.

Mr. SANGMEISTER. Suppose we amended the legislation and brought it right up to the same standards that the SBA has. Is that then merely duplicative or do you see any incentive to do that?

In other words, I guess my question is: how well is the SBA working as far as you are concerned?

Mr. TERRELL. Well, I do not think the SBA 7(a) program is a perfect program at all. I think there are concerns many people have about the way the program is administered, which is a different discussion, but I guess my point is not that that program is perfect. I guess I am saying that it is ongoing. There is a lot of history with it. People have followed it. It is much easier probably to make some refinements in that program than to establish a stand-alone program, even if it were 90 percent guaranteed.

Mr. SANGMEISTER. You heard Mr Rohde testify about his Capital Access Program. Have you ever heard of that before?

Mr. TERRELL. No, I have not.

Mr. SANGMEISTER. Okay. So that is new. This may be rather difficult to ask you, but do you have any comments on it or any thoughts on it, having just heard it this morning?

Mr. TERRELL. I just heard it this morning. One brief comment, I think it sounds very interesting, but I think the idea of first loss protection for lenders is a key ingredient in that program, as well. That is to say that there is some amount of money, a pool of money, to look to before the lender has to come out of his pocket in that program, as I understand it.

Mr. ROHDE. It does do that, yes.

Mr. TERRELL. In that program, the lender has to be wary about his management of the loan and servicing because he knows that after that pool of money is expended, it is on his dime. So I think with that incentive, that creates better lenders and a tighter program overall.

So from what I know it sounds like a decent program.

Mr. SANGMEISTER. The gentleman from South Carolina, Mr. Spence.

Mr. SPENCE. Thank you, Mr. Chairman. You have covered most of it, all of my questions, as a matter of fact, except maybe one. Mr. Rohde, did you say that it would be better off if it was more broad-based, serving more people than just veterans?

Mr. ROHDE. Yes, I did, sir. In fact, my judgment is that if the Congress attempted to implement it just for veterans, the program would not be effective because I think very few banks would want to use that program because they would not have confidence in being able to build up a significant portfolio of loans fast enough to take effective advantage of the portfolio insurance concept.

And this is a general principle. It is not just veterans versus non-veterans. Several years ago somebody in the United States Senate introduced a bill trying to model the Michigan program and said it was just for rural areas, and I had the same comment then. You have to make it broad-based.

And let me illustrate that. In Michigan, when we first implemented the program, the original statute that created the authority for the state agency, the Michigan Strategic Fund that developed the program, prohibited the program from being used for retail businesses. So we went ahead and implemented it without that ability to do retail business, and then we went to the legislature and urged them to change that because, given the structure of the program, that would make the program more effective.

We actually had the Michigan Manufacturers Association come in and testify in favor of expanding it to retail because they understood that the broader the base of the program, the more effective the portfolio insurance concept can be used and the more loans that would be made to manufacturing companies.

So it is not a zero sum game, and that is a general principle that really applies across the board to this portfolio insurance concept.

Mr. SPENCE. Mr. Terrell, would you agree with that?

Mr. TERRELL. Based on what I know of the program, yes, I would agree with that.

Mr. SPENCE. But you said that you thought that the existing programs could be modified maybe to accommodate this program better than just starting a new program from scratch.

Mr. TERRELL. Well, I guess, Congressman, I was comparing the 7(a) program versus the proposed program, but from what I know about this new alternative to what is being proposed by my colleague on this panel, it sounds as though that may be something to pursue. I do not know enough about it to know all of the pluses and minuses, but I think comparing the VA proposal versus the current 7(a) program, I think it is easier to make refinements to the current program than to start a new program, but this is a little bit different.

Mr. ROHDE. If I could add, I think the reason why the Capital Access Program may be worth considering is different from the comment that Mr. Terrell, I think, effectively made relating to the proposed VA program again goes back to the notion that the VA proposed program was simply trying to use the same loan-by-loan guarantee approach, and there really are tradeoffs in amending that approach.

You can make it less bureaucratic, on the one hand, but then you make it less effective as a tool to take more risk. The reason the Capital Access Program can be a good complement to the SBA program is it takes a whole different approach, the portfolio insurance approach, and that adds a whole new dimension particularly for the small loans.

As I said, almost 90 percent of the loans under the Capital Access Program of Michigan have been for under $100,000, which is the precise area that the VA was trying to target.

Mr. SPENCE. Thank you, Mr. Chairman.

Mr. SANGMEISTER. The gentleman from Georgia.

Mr. BISHOP. Thank you very much, Mr. Chairman.

To Mr. Rohde and to Mr. Terrell, I appreciate your comments. My question really has to do with how we can make the loans more available to veterans, and I hear you suggesting that perhaps some marrying of the proposed programs and the new program with the existing 7(a).

But based on your experience and your knowledge of the market, is the real problem that inhibits veteran participation a lack of enough capital in the pool to start with, or is it some of these other factors? I mean tell me what is it. Is it that the banks have the capital, but because of one reason or another they do not feel that the veteran is a good risk and, therefore, would rather have the 90 percent guarantees and those allocations are quickly used up, or is it something else?

Should we be talking about increasing the size of the allocation, which is, I guess, an appropriations issue or an authorization issue as opposed to dealing with modifications to the program?

Mr. TERRELL. Yes, Congressman. I am not adequately skilled to talk about the problems of veterans in seeking out small business loans. I would say generically in the marketplace every lender grades loans and borrowers. We know that, and we know that a lender might view any small business loan as being inherently more risky, and as a subset of that, a small business started by a veteran, for maybe all of the wrong reasons, may view it as even riskier still.

If that is true, and I think that is true, rightly or wrongly, in the minds of many lenders, then I think they do seek more comfort.

They do have more comfort with a program that has a greater guarantee.

I think that is why we believe that the 7(a) program probably makes sense, to refine that, and the refinements from our point of view that we can think of are just more facilitation between the VA and the SBA. It is more out of ignorance. We are not sure if that has taken place before. We know that there has been a VA program before for small business loans. I think it had some success, but it had some high losses as well. I do not know all of the ins and outs of that program, but it seems to us that the prospect of marrying these two ideas does make some sense.

I do not know what percentage of the current small business 7(a) program has veterans in it. Do I believe that percentage could be increased? I think so, with greater facilitation between the two agencies. I guess that is my point.

I think that there is a separate funding issue with respect to the 7(a) program itself.

Mr. BISHOP. Excuse me, if I may interrupt you. It is my understanding that each region of the country served by a regional administrator is given a certain allocation for both direct and the guaranteed loans, and I guess I was trying to hear from, and maybe you can address it also, Mr. Rohde, whether or not the allocation is too small to adequately accommodate the applicant pool.

I do not know the answer to that, and you may not either.

Mr. ROHDE. Yes, if I could give you my perceptive on it, as I understand it, historically most of the time the amount that has been allocated for the SBA program has been sufficient to meet market demand.

Now, we are in the unusual situation where that is not the case at the moment, and the allocation that had been made for this fiscal year, as I understand it, has already been used, and in fact, as a result, the SBA 7(a) program is effectively shut down. There was a proposal to increase that allocation that was in President Clinton's economic stimulus package that passed this body, but as you know, bogged down in the Senate, and it is because of that filibuster on the Senate side and that package not passing that the SBA program, as I understand it, is now pretty much dead in the water until there is some sort of supplemental passed.

However, I think there is another point that should be made. Even assuming that that is passed and that going forward there is a full allocation of resources to meet market demand of SBA, my view is that there is still, particularly for the smaller loans, underutilized needs that are not being met that could be effectively met with another tool.

And the reason is that although the SBA program has certainly grown in use in recent years, there are still an awful lot of banks that shy away from using the SBA program because they feel, rightly or wrongly, it is too bureaucratic.

One of the things that the Capital Access Program does is, because there is essentially zero bureaucracy, there is no prior review; there is only a one-page form to send in after the fact, is it has drawn in a lot of banks in Michigan and now in some of the other states, and there are at least six other states that have actually implemented the program and actually have had loans booked;

draws in a lot of other banks to using the program, and even those banks or the largest users of the SBA program in Michigan have also been very effective users of the Capital Access Program for certain types of loans that they cannot use the SBA program for.

So my point is that you can expand the entire market there and let that be a market-driven thing by having a complementary tool, which I think the Capital Access Program is, if it is implemented on a broad-based manner.

Mr. SANGMEISTER. Okay. Mr. Rohde, this Capital Access Program does pique one's interest. One thing I do not understand is how this reserve fund is set up. Is this a reserve fund that each participatory bank has, or do you have a group of banks that come together and have this reserve fund?

Otherwise, I see that you would have to be doing an awful lot of these loans to build up that reserve fund.

Mr. ROHDE. Right.

Mr. SANGMEISTER. The question is: is it one bank that has its own reserve account or is there a group of banks that participate?

Mr. ROHDE. There are a number of banks that participate, but there is a separate reserve account for each bank.

Mr. SANGMEISTER. So if you have a loss, you do not draw over into the other person's account?

Mr. ROHDE. Exactly, and that is the key to it, so that each bank is in control of its own loss rate. They know that if they manage their risk taking on the special portfolio of loans within the coverage provided by the reserve, they can be fully protected because if any of those loans have a loss, the full amount on the reserve account is available to cover any amount of loss.

If they had to rely on other banks being prudent, then the incentive would not work, but it is precisely because of that that, yes, there has to be a separate portfolio on a bank-by-bank basis that it is so important to make it effective to implement it in a broad-based eligibility, to give each bank an ability to develop their own portfolio.

Technically, it also should be understood that the monies represented by the balance in the reserve account is not the property or is not owned by the bank, but its sole purpose is to be earmarked to cover that bank's losses, and they can get access to it to cover their losses, and so they, in effect, take a very proprietary interest in building up that reserve account and protecting it.

Mr. SANGMEISTER. Suppose it is never drawn against. What happens to those funds? You say they are not the bank's.

Mr. ROHDE. Well, in effect, what happens is if the reserve accounts build up as banks make loans and loans pay off, that reserve account will keep building, and it creates even more of an incentive for the bank to say, well, we have been able to use this program to take some risk, and we are not having losses. Then there is this big reserve account. We can even take more risk and use it even more effectively to expand the number of customers we can finance.

Ultimately, the monies in those reserve funds as implemented by the states are technically the properties of the states, but it is legally earmarked, in effect, forever to cover that bank's losses. If implemented the way I am suggesting on a Federal level, actually the

Federal Government could collect fees from the banks, set up these reserve accounts, but do it as an administrative bookkeeping matter and support it not through cash, but through a guarantee, a full faith and credit guarantee, and then if there were ever losses and the amount of fees collected on a program-wide basis were not sufficient——

Mr. SANGMEISTER. Well, let me see if I can get a comparison.

Mr. ROHDE. Yes.

Mr. SANGMEISTER. I know you are starting to say how this could work at the Federal level.

Mr. ROHDE. Right.

Mr. SANGMEISTER. But let me fully understand how it works in Michigan.

Mr. ROHDE. Sure.

Mr. SANGMEISTER. I am a veteran. I come in, and I negotiate this loan. Then, at the time of the closing of the loan, I am charged what amount that goes into this reserve?

Mr. ROHDE. Well, the borrower pays an amount which is anywhere from 1½ to 3½ percent of the loan amount. The bank matches that, but the bank is allowed to recover the cost through the pricing of the loan.

Some banks just bump up the interest rate a little bit. Most of them pass the bank's fee on to the customer because the bank is still in business to cover its costs and make a profit.

So as a practical matter, in most cases the borrower pays as an up-front fee both the borrower's portion and the bank's portion, which is anywhere from 3 to 7 percent. The average in Michigan is about 3.6 percent total borrower and bank contribution, with the borrower ultimately really picking up that cost.

It goes into this reserve fund, which is earmarked for the bank. In Michigan, the way we implement it is the Michigan Strategic Fund, which is the relevant state agency, simply opened up a deposit account at the bank. So it is the state's money, but there is a deposit account at that bank with the money in that reserve, and then there is a matching payment from the state which matches the combined total of the borrower's payment and the bank's payment.

Mr. SANGMEISTER. Does the general assembly fund that every year?

Mr. ROHDE. You basically fund it on an ongoing basis for each reserve account each time a loan is made, and the State of Michigan initially allocated $5 million to make deposits in that reserve fund. That was seven years ago. A little over $4.5 million of that has actually been deposited in those reserve accounts. It supported about 2,100 loans to about 2,100 companies, averaging $50,000.

The state has since, several years ago, allocated an additional $9 million for deposits, which has not even been used yet, but they always wanted to stay ahead of the game so that the banks could look at this as a long-term program. That is, I think, very important for banks to think of it long term and think that they are positioning themselves long term to build up this reserve fund and have as an effective tool to serve their customers on a long-term basis.

Mr. SANGMEISTER. So, if you were to implement this program at the Federal level, then obviously you would be using the same type of approach, perhaps the same percentages by the borrower, by the lender, and then you would have the VA fill in the slot, which is now done by the Michigan Strategic Fund. Is that what you would be proposing?

I do not want to put words in your mouth. I am just asking.

Mr. ROHDE. Well, I think the basic structure of the reserve accounts could be the same in terms of the fees. There would need to be a decision about what agency would implement it, and if it were the Department of Veterans Affairs, you know, I suppose that would be fine as long as the Congress felt comfortable in giving a program to the Department of Veterans Affairs that would not be in any way limited or targeted to veterans.

That is a jurisdictional issue, but some Federal agency would implement it, but the only difference that I am suggesting, which would make it even more cost effective, instead of funding these reserve accounts with a cash deposit at each bank, you have an administrative account and say that the Federal Government will pay claims up to the balance in that account.

The Federal Government takes the fees that the borrower and the bank pays in, puts that in a separate pool, and then uses that money to pay off claims, and only if the claims were to exceed the amount of fees would you even have to use any Federal resources.

The experience in Michigan suggests that, in effect, the program would pay for itself if used on this full faith and credit guarantee approach, without having to fund the reserve accounts through cash deposits.

Mr. SANGMEISTER. Mr. Terrell, can you sell those in the secondary market?

Mr. TERRELL. Well, I was just thinking about it, Mr. Chairman. I think that we can sell many things. I think that is a little bit more complicated to sell than the current program, and I think it is a higher yield, but I think it could be salable.

I think at some level you have got to pay some cost on the Federal dollars that are put in any program, and I think this is a cost efficient program from the perspective of the borrower because you are borrowing 90 percent of the loan or the entire amount that is traded in the secondary market in the 7(a) program is Federal Government guaranteed. This, as I understand it, will not be the same as that and should trade at a higher rate.

Mr. ROHDE. In fact, as a practical matter, I think I should observe for the benefit of the committee that I do not think that this is a particularly effective tool to sell in the secondary market because the only way you could effectively do that, I think, is basically for the bank to sell its entire portfolio and, in effect, market it to the same buyer because the holder of any loan really needs to look at the quality of the whole portfolio versus what is in that reserve account, and whether that reserve account is adequate.

So it really is, in fact, designed as a program for banks that are going to keep the loans in their portfolio. That is another example of the way it complements what the SBA can do, and in fact, the fact that these loans have not been sold in the secondary market has not prevented it from being a highly successful program which

the banks in Michigan have enthusiastically embraced and used very aggressively.

Mr. TERRELL. I would offer just one comment, Mr. Chairman. I think that there are probably limitations to that approach, depending on what your loan size is and how large the program grows. At some point banks who are less desirous of being portfolio lenders will desire liquidity by selling loans. So if the program is limited to $50,000, I think it is one thing. I think if the program is a lot larger and grows to be much larger, I think there could be limits on lenders' capacity to make loans.

Mr. ROHDE. If I can offer another observation, the average loan is $50,000. There have been loans as high as $1.7 million in the program. It is conceivably true that one of the things that has targeted 90 percent of the loans of less than $100,000 is the lack of a secondary market outlet.

But as a practical matter, even with the very aggressive use of the program, the amount of loans when you are focusing mainly on small loans compared to the total portfolio is small enough so that the lack of a secondary market outlet, you know, in talking to banks has not been a drawback.

So I think the kind of success that we have had in Michigan could be implemented nationwide, and you do not have to put any caps on the loan amount, but again, this is an example of why it complements the SBA, and it is not proposed as a substitute for the SBA. It is a complement.

Mr. SANGMEISTER. Mr. Bishop, Mr. Spence, anything further?

Okay. I thank you both. I think it has been very enlightening and, Mr. Terrell, your comments explaining the present SBA program were very important. Yours Mr. Rohde, your new concept we may contemplate. I presume if we decide to look into this a little further we can count on your cooperation with me and staff, is that correct?

Mr. ROHDE. Absolutely.

Mr. SANGMEISTER. Okay. Thank you very much. Thank you, gentlemen.

I would appreciate the second panel coming forward. Mr. Pedigo, Director of the Loan Guaranty Service of the Department of Veterans Affairs, accompanied by Mr. James Kane, the Assistant General Counsel, and Mr. John Cox, who is the Director of the Office of Financing of the SBA.

Gentlemen, thank you for being here.

Mr. Pedigo, why don't we start with you.

STATEMENT OF KEITH PEDIGO, DIRECTOR, LOAN GUARANTY SERVICE, DEPARTMENT OF VETERANS AFFAIRS, ACCOMPANIED BY JAMES KANE, ASSISTANT GENERAL COUNSEL; AND JOHN COX, DIRECTOR, OFFICE OF FINANCING, SMALL BUSINESS ADMINISTRATION

STATEMENT OF KEITH PEDIGO

Mr. PEDIGO. Thank you, and good morning, Mr. Chairman, members of the subcommittee.

I am pleased to be here today to talk about the Veterans Small Business Loan Act of 1993. Mr. Chairman, with me today to my

right is Mr. James Kane, who is the Assistant General Counsel for the VA.

Mr. Chairman, I would first like to briefly review the history of the VA small business loan program. VA was authorized to guarantee business loans by the Serviceman's Readjustment Act of 1944. VA's guarantee was limited to $2,000 or, if the business loan was used to acquire real property, $4,000.

At the peak of this program in 1951, VA guaranteed about 42,000 business loans. Unlike the home loan program, the amount of the business loan guarantee was not increased to keep up with inflation.

In addition, more attractive loans became available through the Small Business Administration, and business loan entitlement was not extended to post-Korean Conflict veterans.

As a result, by the early 1970's, the VA business loan program became virtually dormant. In fiscal year 1974, VA guaranteed only two business loans. Therefore, VA's business loan program was repealed by Public Law 93-569, effective December of 1974.

Revised authority for a VA small business loan program was enacted by Public Law 97-72 in November of 1981. Although the statute authorized VA to guarantee or make small business loans, funds were never appropriated to implement the program.

Therefore, the September 1986 sunset for this program came without a single loan having been made or guaranteed. This draft bill would revive and revise that program.

The small business loan program proposed by the draft bill would provide loan guarantees. Authority for direct business loans would not be included. The maximum loan amount would be $100,000, and VA's guarantee would be limited to 50 percent of the loan.

Mr. Chairman, the draft bill would require that the small business concern pay a 2 percent loan funding fee. An additional 2 percent loan guarantee fee would be paid either by the small business concern or the lender seeking the guarantee as negotiated between the parties.

All loans would be made on the automatic basis. VA would not review or approve any loan prior to closing. Only lenders subject to federal or state examination and supervision, state agencies, or lenders approved as certified or preferred by the Small Business Administration would be eligible to make loans under this proposed program.

In the event of default on a guaranteed loan, VA would pay a claim to the holder. VA's authority to guarantee loans under this program would terminate in September of 1998.

Mr. Chairman, we are fully sympathetic with the objective of the draft bill, that is, improving small business opportunities for veterans. However, before new policies are considered, we need to carefully examine two major issues.

First, the legislation is in conflict with the Federal Credit Reform Act of 1990. The bill establishes a revolving fund which is precluded by the Act.

In addition, the Federal Credit Reform Act requires that a subsidy appropriation be established to cover the cost to the government before any Federal loan guarantees are committed. Still another

subsidy appropriation would be required to support administrative expenses. The bill does not address either of these subsidies.

Second, we believe the program structure would need to be carefully examined, especially with respect to lender's risk. The draft bill does not clearly state whether a lender would be able to require that the loan be secured.

If the program were to be structured so that the loans have a 50 percent government guarantee, but have no other security, lenders' funds would be at substantial risk. Accordingly, lenders would act with due diligence and generally make such unsecured loans only to the most credit-worthy, experienced borrowers.

We cannot be certain, therefore, how many veterans would actually be able to meet a lender's strict criteria under such a program. We suspect that most of those who would qualify for such loans would already be able to obtain financing either through the SBA program or from conventional sources.

If, however, the program were to be structured to serve a significantly larger number of veterans, we believe lenders would require that the loans be secured either by business or personal assets of the borrowers. If a lender has a 50 percent VA guarantee and also security equal to at least 50 percent of the loan amount, the risk to the lender would be minimal. Under such an arrangement, even with careful underwriting, we would expect a default rate at least equal to the 19 percent default rate on comparable SBA loans. Thus, the subsidy appropriation required to implement this program could be substantial.

For these reasons, we believe more study is needed before establishing a new program within VA.

This completes my statement, Mr. Chairman. I would be pleased to respond to any questions you or any members of the subcommittee may have.

[The prepared statement of Mr. Pedigo appears on p. 78.]

Mr. SANGMEISTER. Okay. Thank you.

Before we have any questions, why don't we go ahead, and let's get the SBA side of this.

Mr. PEDIGO. Okay.

Mr. SANGMEISTER. Mr. Cox, would you proceed, please.

STATEMENT OF JOHN COX

Mr. Cox. Thank you.

Mr. Chairman and members of this committee, I am John Cox, Director of the Office of Financing for the Small Business Administration.

SBA Administrator, Erskine Bowles, was unable to be here today, but he has asked that I review with you the agency's small business loan program with regard to veterans.

We have considerable experience in lending to these small business concerns. The SBA provides financial assistance to veterans through both guaranteed and direct loans. Our regular 7(a) guaranteed business loans are available to all veterans through local lending institutions. The maximum SBA share of a guaranteed loan is $750,000.

Our direct loans are available only to Vietnam Era and disabled veterans who cannot obtain private sector financing or guarantee assistance under our regular business loan program.

Because funds are limited, the ceiling on direct loans is $150,000 per borrower instead of the statutory ceiling of $350,000.

Our decentralized office network with offices in every state, our well established relationships with small business lenders across the country, and our agency's goal of helping entrepreneurs of all types have allowed us to serve small businesses well, including veteran owned businesses.

As of March 31, 1993, the SBA's loan portfolio included approximately 18,500 business loans made to veterans through our guaranteed and direct loan programs. This is approximately 15 percent of the total number of SBA loans and represents roughly $2.6 billion, or 14 percent of the total dollars outstanding.

In fiscal years 1991 and 1992, and in the first six months of this fiscal year, the agency has increased its business loans to veterans. Attached to my testimony are loan approval figures for this period.

Although Public Law 97-72 authorized the Veterans Administration, now known as the Department of Veterans Affairs, to make and guarantee small business loans, we are advised that funds were never appropriated for this purpose, and no loans were ever made.

However, the Small Business Administration has made more than 2,300 loans for approximately $165 million under the same provisions of Public Law 97-72 and Public Law 97-377 since they were enacted.

Congress has consistently funded this program in SBA's appropriation every year since 1983.

The proposed Veterans Small Business Loan Act has a number of parallels to the SBA's business loan program. It envisions loans made through private sector lending institutions, including SBA's certified and preferred lenders, under a guaranteed loan program administered by the Department of Veterans Affairs.

In reviewing the proposed legislation, we find that it appears to duplicate SBA's business loan program in several key areas. As with other lending institutions, our agency has certain credit and policy requirements that all applicants, including veterans, must meet. Among those are adequate equity investment in the business, evidence of the ability to repay the loan from earnings, and a reasonable amount of collateral to protect the interest of the taxpayer.

The proposed legislation differs from the SBA program by setting a maximum guarantee of 50 percent versus SBA's 90 percent. It establishes a maximum maturity of ten years, compared to SBA's maturity of up to 25 years, and it extends the guarantee to loans made by any state; whereas SBA's guarantee is limited to financial institutions.

Under the pending legislation, the veteran would pay a 2 percent funding fee, plus a 2 percent guarantee fee if the lender chose not to pay it. This would usually amount to a 4 percent fee for the veteran, since lenders in most cases pass guarantee fees on to borrowers, as permitted in both SBA's legislation and the pending legislation.

The proposed legislation also authorizes a secondary market for the DVA guaranteed loans, not unlike the SBA's very active secondary market. SBA's guarantee loans sold in the secondary market are backed by the United States, but the proposed legislation does not specifically provide for the same full faith and credit.

As we understand it, the pending legislation provides the Secretary of Veterans Affairs would pay on a default prior to the sale of collateral. This payment would be calculated by taking the outstanding balance and subtracting an estimate of the value of the collateral and the assets of the business, including goodwill.

Under SBA's program, SBA and the lender share in the sale of the collateral recoveries, and the ultimate loss is in the same proportion as the guarantee.

In another departure from SBA's program, the Secretary of Veterans Affairs would be prevented from obtaining personal guarantees from borrowers, and the borrowers would have no personal liability for losses sustained by failed business, except where fraud, misrepresentation, or bad faith is involved.

It is important to note that both the SBA and the private sector lenders have found through the years of experience that personal guarantees are a critical part of extending credit.

When the proposed legislation's key points are compared to the existing SBA business loan program, it appears that duplication would exist. In light of the facts and the issues that have been raised by the bill, we would suggest that the committee defer action until these issues can be considered more thoroughly.

Thank you for allowing me to appear before you, and I'd be pleased to address any questions.

[The prepared statement of Mr. Cox appears on p. 83.]

Mr. SANGMEISTER. Again, thank you both for being here, and let's see if we can get something resolved between the two agencies.

Mr. Pedigo, starting with you, I quoted from the press release that was issued last fall, some time in October, I believe, and staff tells me as a result of that press release going out, we received numerous calls, as I presume VA must have, from veterans wanting to know about this brand new program, and they wanted to be involved in a small business venture.

In light of a change in Administration and a new Secretary, I guess the first question would be are you reluctant on the basis of the cost? Is there some other change of feeling on behalf of the VA?

Mr. PEDIGO. Mr. Chairman, I guess there has been a slight change of feeling at the VA. I think the current leadership at VA clearly thinks that it is a good idea to have some type of viable business loan program for veterans, particularly those who are seeking loans at $100,000 or less.

But our concerns are those stated in our testimony, plus the fact that we do feel that the Small Business Administration program has been fairly effective in addressing the needs of most veterans. It is our opinion that it would be inappropriate to dramatically duplicate programs in the Federal Government. We believe that if we were to provide some enhancements to the Small Business Administration program that specifically address some of the objectives of

the current proposal, that this might be more cost effective than creating a second program in the Department of Veterans Affairs.

Mr. SANGMEISTER. I presume if you're a veteran and you want a small business loan, you would go to your local veteran organization first or write to the Department. Would the Department have a procedure in place? You would direct them right over to the SBA and say, "Yes, there is a program, the 7(a) program, but it is administered through the SBA"? Is that kind of the way it is handled today?

Mr. PEDIGO. Yes, that is exactly the way it is handled. We tell veterans who are interested in getting a business loan that the SBA is the government source of guaranteed financing, as well as direct loan financing, for business purposes.

Mr. SANGMEISTER. Can you tell us the feedback you are getting from veterans as to whether or not they are satisfied with the treatment from SBA?

Mr. PEDIGO. The feedback that we get, which is anecdotal in nature, is that most veterans that we refer to the SBA do not end up coming back to us, saying that they are unable to obtain financing.

Mr. SANGMEISTER. Do not, you said? They do not come back?

Mr. PEDIGO. Yes, they do not come back. Now, that does not necessarily mean that they are successful when they go to the SBA, but we get very little feedback from veterans saying that they have not been successful in obtaining business loan financing.

Mr. SANGMEISTER. According to figures furnished by Mr. Cox, veteran loan approvals, most of which are under that 7(a) guarantee authority, in 1991, there were 3,049. That number went up to 3,708 in 1992, and you are at 1,971 through 1993 so far. I see with that figure you could very likely have an increase over 1992. Is that correct?

Mr. COX. Yes. We are finding that the percentage of increase in the veterans loans about parallel to the increase in our normal 7(a) program. We are increasing about 30 to 35 percent a year in all our loan programs.

Mr. SANGMEISTER. From the standpoint of a veteran is there a program that we can put together in cooperation with SBA so that veterans, particularly those who want loans under $100,000, are better serviced? Do you have any suggestions along that line, or is your position that you are doing the job that should be done and it is adequate.

Mr. COX. No, I think any program can be better run any time. We are always trying to improve our programs.

I think the problem of the veteran not being able to get $100,000 parallels the nonveteran. Small loans are very difficult to get from lending institutions. One thing that was not brought up in the prior panel was the cost of making a $100,000 loan versus a $500,000 loan. Banks are very profit oriented, as well they should be, and so it is difficult across the board to get lenders to make $100,000 loans.

To address that issue, the SBA has tried splitting our guarantee fee of $50,000 and under. We have gotten some results on that, but still not the results that we would like to see.

Most recently, we were given a program called the micro loan program where we are installing nonprofit organizations, where they will make loans up to $25,000. SBA makes a direct loan to these organizations, which goes into a relending pool. Shortly we will have 96 lenders across the Nation under that pilot program.

There is always, you know, something that we should try, something to improve our program. I share the points of the first panel that it may be very difficult to get a separate program started and get the attention of the lenders.

One of the benefits of working with SBA is that we could pool those small loans with the larger loans, and we have got a market all created. So in pooling them, rather than pooling a lot of $100,000 loans which may be difficult to sell, we could put those with our larger pools that we sell right now.

We sell approximately 50 percent of our loans on the secondary market. Last year we did something like $5.6 billion, and 50 percent of those were sold, returning the money to the banks.

Mr. SANGMEISTER. Every loan, of course, has to stand on its own merit. When I was practicing law, I had some clients who were applying for the loan, and I had some severe thoughts about whether the lending institution or the SBA ought to be making that particular loan because they, I thought, were overextending themselves.

Along that line, is there any policy, written or unwritten, that if a Vietnam or Desert Storm veteran comes in, there is a little bit extra effort because he is a veteran over a nonveteran looking for an SBA loan?

Mr. Cox. The credit standards are the same on it. In other words, either they meet the standards that the agency has set or the loan is declined. We do tend to give longer maturities to veterans or low income people or start-up businesses because of the cash flow, and we do put veterans' applications on the top of the pile on the day that they come in, and that is the commitment on the law when it was passed on special consideration.

But as far as approving a loan that is below the standards, we would not do that.

Mr. SANGMEISTER. Both of you were present, I believe, at the time that Mr. Rohde testified on the Michigan program, which is called the Capital Access Program. Do either of you have any thoughts or comments? Could the VA be the State of Michigan's repository for aspects of picking up that program, or doesn't that program make any sense?

It intrigues me a little bit. That is why I asked the question.

Mr. Cox. Yes. We had reviewed that plan several months ago, in fact, on two occasions, and the plan has a lot of merit to it. There are two drawbacks that we saw in the program.

Number one, as we understood it, the reserve would be made up of contributions from the small businesses in the State of Michigan. The bank, the lender, would not contribute to that loss reserve.

The bank would only sustain losses if the losses on the loans that they made exceeded the reserve requirement. That posed a problem in our view. We find that it is very critical that the lender has from day one an interest in that loan.

So under our 90 percent guarantee program or our 85 percent or our 80, from day one that lender has an interest. In the Michigan plan, they would not have an interest unless their losses exceeded the reserve.

The total reserve was something like or could be as high as 14 percent. Now, it is hard to see where you are lending across the board that reserves would exceed the 14 percent limit at that point. So basically the lender in that case would be into the loan with nothing and getting market rates on it. That was one drawback.

The other drawback was that the program was open to all lenders, whether they had business loan experience or not, and we have found that not to be palatable.

Mr. SANGMEISTER. Mr. Pedigo, have you got any comments on the program?

Mr. PEDIGO. Well, I would, first of all, defer to the considerable expertise of the gentleman from the Small Business Administration and make it clear that none of us at VA, at least none of us in the loan guarantee program, profess to have much expertise in the area of business lending. Our primary business has been mortgage lending.

In listening to the explanation of the Michigan program, it certainly sounds like it has some merit, at least enough to warrant further analysis by the staff at VA. I am anxious to learn a little bit more about how it works because in some respects it seems to be similar to a program that the VA had back in the 1940's, 1950's and 1960's for home loans.

Running parallel with our guaranteed loan program we had an insurance loan program under which lenders were able to make loans to veterans and build up credits in a reserve account that could be used to defray the cost of any expenses that might result from a foreclosure. That program was fairly successful in the early years of our program.

But gradually lenders started to prefer the guarantee that the VA offered over the insurance program. At this point, I think we would like to analyze the Michigan program a little further.

Mr. SANGMEISTER. During Mr. Cox's testimony, I saw Mr. Rohde sitting back there shaking his head back and forth. I am tempted to call him back up. Do you have any other comments that you would like to make in relation to Mr. Cox's?

So that we get this on record, take the microphone in front of Mr. Cox there.

Mr. ROHDE. Yes, thank you, Mr. Chairman, for the opportunity to offer some comments on Mr. Cox's observations.

Mr. SANGMEISTER. Yes.

Mr. ROHDE. The first concern was that the lender would not have an interest in the loan or would not have a concern about prudence, and in fact, it works just the opposite.

There is a very strong incentive for prudence because the lender knows that if the lender is trying to protect the overall reserve fund, and the lender knows that if they have too many of the loans they make under the program go bad, that reserve fund is going to be wiped out, and that is the last thing they want to do. It is a very strong proprietary interest in protecting the overall reserve fund.

So, in fact, there is a very powerful interest which I think is really in many ways stronger than is provided where 90 percent of the loan is guaranteed, and the lenders are very careful about that, and the proof is in the pudding.

The loss rates have been very manageable.

The second thing is that it is not correct that the program is open to lenders without business loan experience. In fact, one of the findings in certifying a bank for participation, and it is limited to depository institutions, is that the bank itself have commercial loan experience or that, in the case of a new bank which may not, that they have on staff people with commercial lending experience. So that is part of the certification process.

It is a broad program, and banks are offered the opportunity to come in and participate, and the incentives are there for prudence, and that has been the experience in seven years in Michigan with roughly now 2,100 companies financed, and it has been very prudently managed because the incentives are built right into the program structure.

Thank you.

Mr. SANGMEISTER. Okay. Thank you.

Mr. Cox, if you wanted to respond to that, I would give you an opportunity.

Mr. Cox. No.

Mr. SANGMEISTER. All right. Very good.

I have had the floor here too long. Mr. Spence.

Mr. SPENCE. Well, again, Mr. Chairman, I think you have covered it. I have been sitting here listening to these panels, and I think it is coming through to me from all of them in different ways, maybe in different variations of it, that there is a need for what we are trying to do. But there is concern about duplication and also the possibility of the unneeded structure of a new program. We could probably change the existing programs or modify them to accommodate what we are trying to accomplish.

Then your question was about what could be done to do that. Mr. Pedigo, you were mentioning the present program needs some enhancement, but you did not enumerate what it might be. Could you elaborate a little bit on that?

Mr. PEDIGO. No, I cannot, Mr. Spence, and the reason is that, quite honestly, VA Loan Guranty personnel do not have a high degree of knowledge about the SBA program. All of that experience is at SBA.

What I would suggest that we need to do is work with the SBA, and using them as a resource, try to come up with some changes that might be proposed to their statute that might make for a more viable program for veterans who are seeking loans under $100,000.

Mr. SPENCE. That is the point I wanted to make, Mr. Chairman. That is all I have.

Mr. SANGMEISTER. Okay. Thank you very much. It has been very helpful to have you both here and to get the comparison, and where we are going to go with this is getting some direction today. I can tell you that right now, but it is never fully done until we hear from the veterans' organizations, which will be next, but thank you both, gentlemen.

Mr. PEDIGO. Thank you.

Mr. Cox. Thank you.

Mr. SANGMEISTER. The next, and last panel that we have is Mr. Clifton Dupree, who is the Associate Legislative Director of the Paralyzed Veterans of America; Mr. James Magill, who is the Legislative Director of the VFW; Mr. William Crandell, who is the Legislative Advocate of the Vietnam Veterans of America, accompanied by Mr. Paul Egan; and the Veterans Transition Franchise Initiative, represented by Mr. Donald Dwyer all the way from Waco, TX.

So we welcome all of you here, and why don't we just take you in the order of your introductions, and let's start with Mr. Dupree.

STATEMENTS OF CLIFTON E. DUPREE, ASSOCIATE LEGISLATIVE DIRECTOR, PARALYZED VETERANS OF AMERICA; JAMES N. MAGILL, LEGISLATIVE DIRECTOR, VETERANS OF FOREIGN WARS; WILLIAM F. CRANDELL, LEGISLATIVE ADVOCATE, VIETNAM VETERANS OF AMERICA, ACCOMPANIED BY PAUL S. EGAN, EXECUTIVE DIRECTOR; AND DONALD DWYER, VETERANS TRANSITION FRANCHISE INITIATIVE

STATEMENT OF CLIFTON E. DUPREE

Mr. DUPREE. Thank you, Mr. Chairman and members of the subcommittee. Paralyzed Veterans of America thanks you for inviting us to testify today.

To start with, we strongly support the legislative proposal as was talked about this morning. Mr. Chairman, PVA has contended for many years that——

Mr. SANGMEISTER. Can I interrupt you? The proposal as written, considering some of the comparisons we have heard, or as it might be improved is what you are saying? Okay. I am sorry. Go ahead.

Mr. DUPREE. No problem.

Anyway, Mr. Chairman, PVA has contended for many years that the VA could do more to promote small business opportunities for veterans, specifically disabled veterans.

The basic consideration provisions and currently designed veterans programs have gone part of the way to assure an emphasis for veterans in the distribution of small business opportunities and services among targeted populations.

There are approximately 3.5 million veteran-owned businesses in the United States, and veterans, particularly Vietnam veterans, have a low rate of business ownership in comparison to other groups. Businesses owned by veterans tend to be newer, smaller, and less secure financially than nonveteran owned concerns.

For disabled veterans, in particular, starting a business presents additional challenges in obtaining capital and maintaining adequate income levels. Disability can bring about unique physical, as well as personal and economic, challenges.

In October of 1992, the Disability Income Systems, Incorporated, in cooperation with the Paralysis Society of America, released a report called Economic Consequences of Traumatic Spinal Cord Injury, Analysis of Post-injury Employment Patterns, and the report stated that spinal cord injured persons injured at working age of 18 through 64 represented 147,000 individuals. This group

best represents those individuals who would face employment decisions after their injuries.

The survey analysis of post-injury employment says that the average months that an individual with a spinal cord injury were not employed immediately after injury exceeded 60 months, and under this survey disabled veterans remain unemployed an average of 90 months immediately after injury.

No other demographic group under age 65 of any size has such a small proportion working. Young blacks, a group often singled out because of their very high level of unemployment, are much more likely to be working than are disabled Americans.

These trends are valid not merely for employment, but for successful self-employment in business ownerships. The physical challenge of a disability is not the only reason an individual cannot find work or gain the experience or financial credit to find a job or start a business.

The Congress and the American people are trying to change both physical barriers in the environment and attitudinal barriers in society that have challenged people with disability.

What PVA would recommend is that this bill be refined further by including certain provisions that would give the VA the ability to apply special attention and consideration for the needs of disabled veterans seeking either to start a business or to enhance a current business operation.

This could be done by allowing disabled veterans to compete for contracts and capital, such as 8(a) and 8(c) minority enterprise programs managed by the Small Business Administration. Disabled veterans should be able to compete for these programs as socially and economically disadvantaged individuals.

Veterans programs, benefits, and services always single out disabled veterans as a priority group needing unique assistance, whether it be for health care, employment, job training, or job placement.

Mr. Chairman, this concludes my testimony, and I will be happy to answer any questions you might have.

[The prepared statement of Mr. Dupree appears on p. 87.]

Mr. SANGMEISTER. All right. We will go on to Mr. Magill.

STATEMENT OF JAMES N. MAGILL

Mr. MAGILL. Thank you for the privilege of the VFW being able to testify at this important hearing.

I would like to start by stating that my remarks are based on my being a veterans' advocate, not one representing for-profit groups. We are here to comment on what is good for the veteran and how a grateful Nation may assist her veterans.

We still strongly believe that veterans comprise a special segment of our population and thus warrant special considerations.

As you stated before, last October the Department of Veterans Affairs announced a new small business loan initiative that was patterned after what we considered the extremely successful home loan guarantee program. It just stands to reason for us that a similar business program can be developed to meet other needs of veterans.

According to VA, approximately 12.8 million veterans who served during and following the Vietnam Era may be eligible to partake in the veterans small business loan program. VA further estimates that approximately 200,000 loans could be guaranteed over the five-year life of the program, beginning in 1993.

VFW commends this initiative in that it has the potential, we believe, to create more than one million jobs, and also, just as important, to help ease the downsizing that the military is experiencing now.

While it is questionable whether SBA did all that it could to qualify veterans for participation in the loan program in its first years, VFW is pleased with the progress that they have made in the last couple of years. We would welcome language stating that nothing in Section 3742 should preclude direct loans to veterans.

We also would recommend a provision that would allow up to three eligible veterans to pool their entitlement. We believe that this would enable each veteran to obtain their cap contained in the draft bill, while at the same time allow for higher working capital that just may be required for certain projects.

This concludes my statement, and at the appropriate time I will be happy to answer any questions you may have.

[The prepared statement of Mr. Magill appears on p. 90.]

Mr. SANGMEISTER. Okay. Mr. Egan or Mr. Crandell.

Mr. EGAN. Thank you, Mr. Chairman.

Mr. SANGMEISTER. Okay. Mr. Egan.

Mr. EGAN. My role here this morning is perfunctory. Bill Crandell has prepared the testimony for Vietnam Veterans of America, and I simply wanted to introduce him to you as the newest member of our legislative staff.

Mr. SANGMEISTER. Welcome, Mr. Crandell, and you may proceed.

STATEMENT OF WILLIAM F. CRANDELL

Mr. CRANDELL. Thank you, Mr. Chairman.

Normally VVA appears here on behalf of those veterans who are least able to help themselves. Today we are here to offer the support of veterans to the economic recovery through a new small business loan initiative for veterans.

There is a real need for a solid program that will loan money to veterans for the creation and support of small businesses. We would support a program that means business, not when it merely looks good.

Investment dollars, which is what small business loans are, must go to good investments, and we believe veterans in business are just that. These men and women constitute a vital resource that this country has, for the most part, tapped only in wartime. The military teaches far more than a specific set of combat or technical skills. Veterans are men and women who understand team work, discipline, setting objectives, and meeting them. They are seasoned at operating under pressure, at finding ways to do what needs doing. We make great entrepreneurs and great employees.

There needs to be an administrative heart in this program to keep such an initiative from being merely money thrown at a prob-

lem. VVA advocates six small steps that would turn the initiative into a real program.

First, administrative coordination with the Small Business Administration.

Second, outreach to veteran business owners.

Third, loans in the $10,000 to $30,000 range geared to the realistic scope of small businesses rather than loans of $100,000. Witness, for instance, the popularity of the new SBA micro loan program.

Fourth, linking veteran entrepreneurs with unemployed or underemployed veterans in cooperation with the Department of Labor's Veterans Employment and Training Services.

Fifth, encouraging veteran entrepreneurs to use SBA technical and management assistance.

And, sixth, refinancing viable loans to avoid foreclosing on businesses that have a chance of succeeding.

Vietnam Veterans of America believes in veterans. If we did not, we would all be in some other line of work. The idea of a veterans small business loan program—because it must be a program and not simply a bunch of loans given out at random—excites us because it offers us a chance to serve once again.

What we are asking you is to create a simple, coordinated effort to find a core of veteran entrepreneurs, loan them reasonable amounts of money, help them stay on track by making seasoned coaching available to them, put them in touch with veterans who need work, and stick with them through hard times.

Veterans are one of our least utilized national resources, one we cannot afford to let rust. Use us.

Mr. Chairman, I welcome questions.

[The prepared statement of Mr. Crandell appears on p. 92.]

Mr. SANGMEISTER. All right. Mr. Dwyer, we would like to hear from you at this point.

STATEMENT OF DONALD DWYER

Mr. DWYER. Well, I am certainly proud to be here with you, Mr. Chairman, and the committee and the other people that are here.

Mr. SANGMEISTER. Thank you.

Give us first a little bit of background of where you come from and how you tie into this. I am sure the other members at the table, as well as committee members here, would like to have a little lead-in about your position.

Mr. DWYER. Yes. I am known as an entrepreneur. I have over 2,000 operations in 19 countries. Our business has been developed in the last 12 years. We are the 25th largest franchise organization in the country. I am a Director of the International Franchise Association. Franchising has 550,000 franchise outlets in the United States and is a virtual economic miracle for this Nation, employing everyone, including veterans, and I happen to be a veteran of the Korean Conflict.

And as I have listened to all of the testimony, I would like to preframe my comments, and my concern is the 80 percent of the veterans who do not have collateral, but have great attitudes, and as General Kelley told me, they have been trained to get to work on time and to follow a system.

So part of my frame is to touch those people, and there are some 25 million veterans out there that need help in getting in their own business.

I would like to couple that with my comments about franchising and how we can actually guarantee the success of veterans that do go into a program that the VA sponsors.

There is a distinction between the VA and the SBA. The SBA is a wonderful organization. They support our program, which is for veterans and I will explain that in a minute. However, I have noticed a difference, and it is not a logistical difference, but it is an emotional difference.

When I got together with Scott Denniston and Sonny Montgomery, having worked with the SBA for some time, there was a different commitment. It was an absolute emotional commitment to veterans, and my feeling is that a program administered by the VA will have a lot more dedication and a lot more punch in terms of taking care of the veterans of America.

That does not diminish the role of the SBA because they are wonderful people and they do a wonderful job.

Let me explain briefly what VET-FRAN is. Actually it came out of this Nation joining forces, working together to show our dedication to those folks that went over to the Middle East. There was an outpouring in this Nation of giving which I have never seen before in my history of this Nation.

And our association, the International Franchise Association, was seeking a way to show our thankfulness for what those veterans were doing over there, and I came up with the idea of helping veterans get into their own business. That had never been done before effectively and certainly was a viable alternative, I think, to veterans who did not want to go back to school and who wanted to really control their own destiny.

So VET-FRAN is a very simple program. It was initiated at the Washington Press Club in Veterans Day 1991, and what 115 franchises have agreed to do is guarantee or finance up to 50 percent or they will finance 50 percent of the veteran's initial licensing fee.

Now, if you couple that with a program that is proposed here with a 50 percent guarantee, you almost have a 100 percent guarantee for a veteran's loan. Now, what is the power of franchising that would insure the success of a veteran or anyone that goes into a franchise?

First of all, business format franchising is tested. The Department of Commerce has come up with figures that 95 percent of the people that enter into a franchise organization will survive in the long run, and a person going into their own business without that kind of support is very, very difficult.

What does a franchise offer? It offers a format that veterans can follow. It makes it easier to make the transition from the military to the civilian sector, there is even a different language that veterans speak when they come out of the military, and they feel very comfortable with the franchise system. They find a safe harbor in franchising because it is very much like the military. Everything is done by the numbers, and that really insures their success.

If they will work hard and they have desire, they can be successful in their own franchise business.

I am concerned especially about the smaller loans, $25,000, $50,000, not $100,000 because most veterans out there will not qualify for a $100,000 loan, and when you look at what franchising can do with the backup and support, with the research and development, with the discounts that they get in products and services, and they are there every single day with toll free Watts lines to help that veteran through the struggle of learning how to be a business person.

Guys, it is not easy to learn how to be a business person, but franchising can provide that support to those veterans on a day-to-day basis.

So my suggestion or my idea is couple the program with VETFRAN, and what you have is a winner for the government, for the SBA, for the VA, and for the veterans. It is very simple. It is not complicated, and it works, and it is working every single day. Franchising is the engine of the economy right now.

[The prepared statement of Mr. Dwyer appears on p. 97.]

Mr. SANGMEISTER. Well, thank you very much. That is very interesting.

I will start with the veterans' organizations. The first question to you is, when the VA made the announcement that we were going to have legislation for special program and it did not materialize, what were you hearing from your members out there?

Mr. MAGILL. Well, first of all, because it just came out as a press release, I am not sure that it really was made aware throughout the United States, but I have mentioned several times to people on the phone, where I told them that this program is in the talking stage right now, and they were all very excited about it.

I have had many follow-up calls since the October press release and also since the time that I have mentioned to inquiries that come to my office. They have called back wondering what is going on with this. I could cite two examples right now just off the top of my head where they basically have a good, solid idea for a business, and they are just waiting and hoping that this program will become a reality.

Mr. SANGMEISTER. When you talk to those people, do you ever say to them, "Well, you know, the SBA has got a program. Have you made application there?"

Mr. MAGILL. They are aware of the SBA small business. A lot of times a veteran, you know, will want to go to the VA. He has had success, again, as I mentioned in my statement. VA has run a heck of a good home loan guarantee program, and the veterans out in Illinois and Wisconsin, Nebraska, they know that.

Mr. SANGMEISTER. Okay, but from what we heard from Mr. Terrell, the SBA guarantees are even better than what the home loan guarantee program is.

Mr. MAGILL. Well, as I stated, too, individuals come before these committees representing various constituencies. I am sure that they would be more in favor of going with a 90 percent guarantee, but as I also stated, veterans comprise a special segment of our population.

When a veteran or when a person went off into the military, my gosh, they were taking more risk than anybody else could imagine, and I really am not too happy about hearing constantly no risk, no

risk. These guys are home now. They need a break. Let them have it.

Mr. SANGMEISTER. Mr. Dwyer said the fact that it would be in a program under the VA would give it that punch. Do you agree with that, that that is the difference between continuing on with the SBA type of program as to having a Veterans Administration program of our own?

Mr. MAGILL. The Veterans Administration is for veterans. I would agree with that. I am not saying that SBA does not do a good job, too. As I stated, in the past couple of years they have shown remarkable progress, and again, give the veteran a choice.

Mr. SANGMEISTER. Okay.

Mr. MAGILL. If he wants to go with SBA, he certainly can. If he wants to go with the guarantee with the VA, I think, over a five-year period, the program would be very successful.

Mr. SANGMEISTER. Do any of the rest of you have any comments?

Mr. EGAN. Mr. Chairman, your first question about what kind of response we got from our members resulting from the issuance of this press release, we had several calls, and the calls we had were from veterans who were extremely excited about this and were anxious to know more about it. Was it in place? When could they expect to begin to take advantage of this?

But I have to tell you that these are pretty much the same kinds of veterans who would call us asking about what there is out there available to acquire small business loans. With or without a proposal of this kind, I think it is important to characterize what kind of loans those people are looking for.

They are not looking for $100,000 to $300,000 loans. They are not looking to open the doors to a Fortune 500 company right from the get-go. They are people who are looking for very small kinds of loans. They are individuals who typically are either underemployed or have been laid off and looking to apply some of the skills that they have acquired in their professions or in their careers. They are people who are looking for small loans.

I think it is important, as Mr. Crandell here pointed out, that we have to put the "small" back into small business loans, and without that a program is not going to be particularly meaningful to most of the veterans that call us interested in small business.

Mr. SANGMEISTER. Mr. Dupree.

Mr. DUPREE. Yes, sir. For most of the veterans in our organization the VA is their livelihood. We have spinal cord injuries. The VA is their life support.

Back in the Persian Gulf War, there was a bill introduced. It was the Entrepreneurship Act to have a special 5 percent set-aside for government contracting for disabled veterans. SBA opposed it.

So we have to stand with the VA. I mean the VA is the people that take care of us, and like we have said before, we have already suffered and sacrificed. Now it is time for somebody to take care of us.

Mr. SANGMEISTER. Mr. Dwyer.

Mr. DWYER. Mr. Chairman, we have gotten 10,000 inquiries from veterans on the VET-FRAN program. Some of the letters and comments have been submitted to you. We have put approximately 300 veterans in their own business through the program. The program

is not supported by the government. It is basically funded privately and is highly successful, given what we have to work with.

The interesting thing and probably the biggest comment is the paper work that they have to complete for an SBA loan is enormous and oftentimes veterans will spend $1,500 to $3,500 to get a packager to put the program together to submit to the SBA with no guarantee that it is going to be accepted, and I think that is a tremendous burden.

The VA program, as I understand it, will be a very simplified application program, and let's face it. We avoid pain and go towards pleasure, and there is a lot of pain if you know nothing about paper work to have to go through that red tape, and we get red tape-itis, and we say, hey, you know, it is not worth it. Let me just go take a nice, low paying, steady job and not have to go through that pain.

I think one of the features we have with the VA program is the simplification of the loan application. That may not seem like much, but every single day I work with these veterans, and I hear the comments that they make.

If you look at Nagel, an association of banker who process SBA loans and talk to Jim Whitney, who is a vice president of American Pacific States Bank, he told us that the small loans are virtually impossible to get made because they are not cost effective for the banks.

So to reinforce the points that have been made here, a $25,000 to $50,000 loan will get a veteran started in business, and those loans are typically not available. Most banks do not make loans to get people into their own business, to start with. So the veteran is shot down before they even get up, and they have been shot enough.

So let's put a program together that is going to make it really happen for them. We are talking here about dollars and cents, and we are forgetting the human element. Dollars and cents does not make success. Success is made by desire and a driven individual who is willing to pay the price to do what has to be done to be successful, and veterans are willing to do that.

By and large, they have paid a price and are willing to pay any price to be successful in society. I do not think we have to give them anything. All we have to do is support them.

Mr. SANGMEISTER. Give me some examples of a franchise that you can do for $25,000 to $50,000.

Mr. DWYER. Jani-King International, you can get in for less than $12,000.

Mr. SANGMEISTER. I am sorry. I did not catch that.

Mr. DWYER. It is called Jani-King International. It is, in fact, a janitorial franchise.

Rainbow International, which is a carpet cleaning and dying franchise; Worldwide Refinishing, which refinishes tubs and tiles. There are a number of franchises you can get into for less than the price of a car, and the franchisor will finance 50 percent. Oftentimes they do more for veterans because they are not just gauging the person's dollars in the bank or his collateral. They are gauging a human being because success is not your collateral. It is your strength and your ability to work and your desire.

I gauge people by desire more than I do by dollars.

Mr. SANGMEISTER. Well, that is interesting, and those type of franchises have worked. Naturally there are always failures, but a good percentage have worked?

Mr. DWYER. Well, I started out as a franchisee. I originally became a regional franchisee and ultimately became a franchisor, and I have people in my organization that we even co-sign loans to get into the business, and a guy named Mike Bidwell in Tucson, AZ, earns $150,000 a year net income, and we had to co-sign a loan to get him into the business.

It is not always the collateral that makes the difference. In fact, some people have collateral, but they have no guts. I would rather have the guy who has got guts and is willing to go out there and work and bust his bunions with our support. We pick up their socks every morning if we have to to get him out there and doing what they are supposed to do.

They need that support. Any small business program that does not have a support infrastructure is not going to succeed as much as if you had that structure. The structure is there. It is called franchising. It is spreading around the world.

I have 50 franchises in South Africa. Most of those people are black South Africans. This is the way to train people how to be successful in business. It is called franchising.

Let's recognize it. It is highly successful. Probably 40 percent of all the goods and services we buy in this room are from franchise outlets, and we do not even recognize it, but that is a fact.

Mr. SANGMEISTER. It is kind of exciting.

Mr. Spence.

Mr. SPENCE. Well, it really sounds good to me.

(Laughter.)

Mr. SPENCE. You have about sold me on one.

Mr. SANGMEISTER. What is available?

Mr. SPENCE. Yes. I am a veteran.

Maybe more of a comment than anything else, Mr. Chairman.

Mr. SANGMEISTER. Go ahead.

Mr. SPENCE. What I am hearing from the veterans panel here is that you support the specific needs of veterans who deserve special consideration because of their service to our country, and I associate myself with that position.

I think the central question we have before us here this morning is whether or not we can accomplish that by the use of a new piece of legislation, a new program, or whether we can modify existing programs with special emphasis put on the veterans and their specific needs.

That is my position. I am desirous of doing just that. Thank you for your help this morning.

Mr. SANGMEISTER. Okay. You are welcome.

I think in summary, as I understand what we have heard this morning, we need to do something. The draft legislation obviously is not the answer at this point because of testimony that we have heard. We have got to do something different.

The Michigan proposal that has been given to us is something we will have to chew on. We will probably be doing something, and I will be working with Mr. Burton and certainly Mr. Spence, who is here today to hear all of this, on the minority side to try to put

together some kind of a package that we will resubmit to everybody and let you take a look at. We will see if we can get involved.

Okay. Thank you all. The committee is adjourned.

[Whereupon, at 11:36 a.m., the subcommittee was adjourned, subject to the call of the chair.]

APPENDIX

PREPARED STATEMENT OF CHAIRMAN SANGMEISTER

The subcommittee will be in order. I am pleased to welcome all of our witnesses here today to explore and discuss a small business loan program for veterans. I look forward to hearing the views of VA, SBA, financial institutions and veterans service organizations.

While the Department of Veterans Affairs had a direct loan program authorized by Public Law 97-72, funds were never appropriated and no loans were ever made or guaranteed. In fact, it is my understanding that the Small Business Administration actually administered a small business loan program specifically for veterans from existing appropriated funds. Yet, the Subcommittee has heard from veterans and service organizations expressing the view that the veterans are not adequately served in their efforts to obtain loans to start small businesses. I am hopeful that from this hearing the Subcommittee will gain insight into this perception—quite simply is it fact or is it fiction.

A review of VA and SBA statistics indicate that the average SBA loan is for $242,000, and only 11 percent of SBA loans are under $100,000. Let me emphasize the draft proposal today seeks to target veterans that desire loans under $100,000. One could argue that these very loan amounts are currently under served by SBA. Such numbers are disturbing when one considers that veterans comprise 20 percent of the small business population, yet they receive less than 14 percent of SBA loans. Providing more loans under $100,000 to veterans, whether by VA under the proposed bill or under existing SBA programs, could lessen this discrepancy.

Under the draft legislation, the maximum loan amount would be $100,000 with a VA-backed guarantee of 50 percent. Fifty-one percent of the small business concern must be owned by eligible veterans. VA's preliminary cost estimates illustrate that the 4 percent collected in fees would recover losses as a result of any estimated loan defaults.

The testimony received today will help determine the advantages and the disadvantages of implementing a new small business loan program for veterans or whether it is best to proceed by better targeting and increasing the number of veterans served by existing SBA programs.

Before we call up the first panel of witnesses, I would like to recognize the Ranking Minority Member, Rep. Dan Burton of Indiana.

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Department of Veterans Affairs

News Release

FOR IMMEDIATE RELEASE

VA SEEKS LEGISLATION FOR VETERANS' SMALL BUSINESS LOAN PROGRAM

Washington, Oct. 28 — The Department of Veterans Affairs (VA) is announcing a new small business loan initiative for veterans that is predicted to create one million jobs and help cushion the impact of the downsizing of the military.

VA will seek legislation for the 5-year program, which would coincide with the military downsizing and would guarantee up to 50 percent of the loan amount — with a maximum loan amount of $100,000 — for land, equipment and other business expenses. An average of $3.6 billion in new business loans is expected to be guaranteed annually, with $1.5 billion in the initial year.

Acting VA Secretary Anthony J. Principi said, "This program will follow in the footsteps of the GI Bill Home Loan program of 45 years ago and will mark a new era toward meeting the needs of veterans who want to start their own businesses. Under this program, it will be easier for veterans to obtain loans, with less red tape, lower interest rates and less collateral."

Small Business Administration (SBA) statistics show that 15 percent of all veterans own small businesses. VA estimates that some 12.8 million veterans who served during and following the Vietnam Era may be eligible. VA further estimates, based on SBA statistics of business formations by veterans, that approximately 200,000 loans would be guaranteed during the life of the program, beginning Oct. 1, 1993. The average small business employs 11 people, according to SBA. If businesses assisted by this program employ just five people, some one million jobs would be created.

-more-

The program would be funded by fees paid at the time the loan is closed: a two-percent funding fee paid by the veteran to VA, and a two-percent loan guarantee fee paid by either the lender or the veteran to VA. The veteran's fees may be added to the loan amount.

As with VA's home loan guarantee program, should a default occur, lenders would submit claims to the department, and VA would pay up to 50 percent of the loan amount.

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(Dist: I,II,2,5,7,9,10)

[DISCUSSION DRAFT]

APRIL 19, 1993

103D CONGRESS
1ST SESSION

H. R. ____

IN THE HOUSE OF REPRESENTATIVES

Mr. SANGMEISTER introduced the following bill; which was referred to the Committee on _____

A BILL

To amend chapter 37 of title 38, United States Code, to establish a small business loan guaranty program for certain veterans.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Veterans' Small Busi-
5 ness Loan Act of 1993".

1 **SEC. 2. REFERENCES TO TITLE 38, UNITED STATES CODE.**

2 Except as otherwise expressly provided, whenever in
3 this Act an amendment or repeal is expressed in terms
4 of an amendment to or repeal of a section or other provi-
5 sion, the reference shall be considered to be made to a
6 section or other provision of title 38, United States Code.

7 **SEC. 3. SMALL BUSINESS LOAN GUARANTEE PROGRAM.**

8 The chapter heading for chapter 37 is amended to
9 read as follows:

10 "SUBCHAPTER IV—SMALL BUSINESS LOAN
11 GUARANTEES".

12 **SEC. 4. ELIGIBLE VETERANS.**

13 Paragraph (2) of section 3741 is amended to read
14 as follows:

15 "(2) The term 'eligible veteran' means—
16 "(A) a disabled veteran;
17 "(B) a veteran who served on active duty
18 at any time during the Vietnam era or the Per-
19 sian Gulf War and whose total service was for
20 90 days or more; or
21 "(C) a veteran, other than a veteran de-
22 scribed in subparagraphs (A) and (B), who
23 served on active duty at any time after May 7,
24 1975, for a period of more than 180 days.".

25 **SEC. 5. SMALL BUSINESS LOAN GUARANTEE PROGRAM.**

26 Section 3742 of chapter 37 is amended as follows:

1 (1) By amending the heading of such section to
2 read as follows:
3 **"§ 3742. Small business loan guarantee program".**
4 (2) Subsection (a) of such section is amended—
5 (A) in paragraph (1)—
6 (i) by inserting "paragraph (2)(A)
7 and" after "Subject to"; and
8 (ii) by striking "financial assistance"
9 and inserting "loan guarantees";
10 (B) by striking paragraph (2) and redesig-
11 nating paragraph (3) as paragraph (2); and
12 (C) in paragraph (2)(A), as redesignated
13 by subparagraph (B) of this paragraph—
14 (i) by striking "individuals who are
15 veterans of the Vietnam era or disabled"
16 and inserting in lieu thereof "eligible"; and
17 (ii) by striking "and at least 51 per-
18 cent of a business concern must be owned
19 by disabled veterans in order for such con-
20 cern to qualify for a direct loan".
21 (3) Subsection (b) of such section is amended—
22 (A) in the matter preceding paragraph (1),
23 by striking "financial assistance" and inserting
24 "a loan guarantee";

1 (B) by striking paragraph (1) and redesig-
2 nating paragraphs (2), (3), and (4) as para-
3 graphs (1), (2), and (3), respectively;
4 (C) in paragraph (2), as redesignated by
5 subparagraph (B) of this paragraph—
6 (i) by striking "make or";
7 (ii) by striking "$200,000" and in-
8 serting "$100,000"; and
9 (iii) by adding at the end the fol-
10 lowing: "A veterans' small business con-
11 cern which either has received less than
12 the maximum allowable loan or has repaid
13 a portion of the maximum allowable loan
14 may, to the extent prescribed in regula-
15 tions, receive one additional loan for the
16 same business concern so long as the
17 aggregate outstanding liability of the Sec-
18 retary under this subchapter with respect
19 to such business concern does not exceed
20 $100,000."; and
21 (D) in paragraph (3), as redesignated by
22 subparagraph (B) of this paragraph, by striking
23 "90" and inserting "50".
24 (4) Subsection (c) of such section is amended—
25 (A) by striking "made or"; and

1 (B) by striking "loan, or so" and inserting
2 "loan guaranty, and so".
3 (5) Such section is amended by amending sub-
4 section (d) to read as follows:
5 "(d) The Secretary may not guarantee a loan under
6 this subchapter to a veterans' small business concern
7 based on an ownership interest of a veteran if that veteran
8 also has or had an ownership interest which was consid-
9 ered in qualifying another small business concern for a
10 loan guarantee under this subchapter, except as provided
11 in subsection (b)(2) of this section.".
12 (6) Such section is amended by amending sub-
13 section (e) to read as follows:
14 "(e) Loans guaranteed under this subchapter shall be
15 made on such other terms, conditions, and restrictions as
16 the Secretary may prescribe.".
17 **SEC. 6. LIABILITY ON LOANS.**
18 Section 3743 of chapter 37 is amended—
19 (1) by striking "that is provided" and all that
20 follows through "subchapter," and inserting "that
21 obtains a loan guaranteed under this subchapter";
22 and
23 (2) by striking "direct or guaranteed" and all
24 that follows through "such loan." and inserting
25 "such loan. The borrower shall have no liability to

1 the Secretary with respect to the loan for any loss
2 resulting from any default of such individual except
3 in the case of fraud, misrepresentation, or bad faith
4 by such individual in obtaining the loan or in con-
5 nection with the loan default.".

6 **SEC. 7. AUTOMATIC GUARANTY.**

7 Section 3744 of chapter 37 is amended to read as
8 follows:

9 **"§ 3744. Automatic guaranty**

10 "Small Business loans will be guaranteed under this
11 subchapter only if made by (1) any financial institution
12 that is subject to examination and supervision by an
13 agency of the United States or of any State, (2) by any
14 State, or (3) by any lender or class of lenders approved
15 as Certified or Preferred by the Small Business
16 Administration.".

17 **SEC. 8. INTEREST ON LOANS.**

18 Section 3745 of chapter 37 is amended by—

19 (1) by striking subsection (b);

20 (2) by striking the second sentence of sub-
21 section (a); and

22 (3) in the first sentence of such section, by
23 striking "(a) Loans" and inserting "Loans".

1 **SEC. 9. MATURITY OF LOANS.**

2 Section 3746 of chapter 37 is amended by striking
3 "made or" both places it appears.

4 **SEC. 10. ELIGIBILITY OF FINANCIAL INSTITUTIONS.**

5 Section 3747 of chapter 37 is amended by striking
6 "an entity" and all that follows through "State." and in-
7 serting "any lender other than a lender described in sec-
8 tion 3744 of this title.".

9 **SEC. 11. LIQUIDATION AND CLAIMS.**

10 Section 3748 of chapter 37 is amended to read as
11 follows:

12 **"§ 3748. Liquidation and claims**

13 "(a) In the event of a default on any loan guaranteed
14 under this subchapter, the holder of the guaranteed por-
15 tion of the loan shall notify the Secretary of such default.
16 Such notice must be received by the Secretary before the
17 default has continued for more than 90 days.

18 "(b) The Secretary's liability under the outstanding
19 guaranty on a loan, subject to the limits specified in sec-
20 tion 3742, shall be equal to the total indebtedness on the
21 loan minus the liquidation value, determined as of the ear-
22 lier of the date of the claim or the cutoff date established
23 under subsection (c) of this section.

24 "(c) The Secretary may establish a cutoff date, not
25 later than the date of the claim, after which accrual of
26 interest and charges to the loan shall cease for purposes

1 of computation of the claim payable. Nothing in this sec-
2 tion shall preclude any forbearance for the benefit of the
3 veteran as may be agreed upon by the parties to the loan
4 and approved by the Secretary.

5 "(d)(1) The holder of a loan guaranteed under this
6 subchapter may file a claim for payment of the guaranty—

7 "(A) at any time after a default has continued
8 for more than 180 days and the notice required by
9 subsection (a) of this section has been filed for the
10 default; or

11 "(B) before the end of the 180-day period re-
12 ferred to in subparagraph (A) with the prior
13 approval of the Secretary or if a cutoff date has
14 been established by the Secretary under subsection
15 (c).

16 "(2) The Secretary shall be subrogated to the rights
17 of the holder of the guaranteed portion of the loan to the
18 extent of the amount paid on the guaranty.

19 "(e) For purposes of this section—

20 "(1) the term 'total indebtedness' means an
21 amount equal to the total of (A) the unpaid prin-
22 cipal of the loan, (B) the interest on the loan as of
23 the cutoff date, and (C) such reasonably necessary
24 and proper charges associated with liquidation of the
25 loan as may be specified in the loan instruments and

1 permitted by regulations prescribed by the Sec-
2 retary;
3 "(2) the term 'liquidation value' means the sum
4 of the value of collateral securing the loan and the
5 value of any equity interest of the business in the
6 assets of the business, including goodwill, as deter-
7 mined by the Secretary as of the cutoff date; and
8 "(3) the term 'default' means the failure of the
9 loan holder to receive a schedule installment pay-
10 ment on or before the date required by the loan in-
11 struments, or the occurrence of any other event or
12 circumstance which, under the terms of the loan in-
13 struments and applicable State law, would permit
14 the loan holder to terminate the loan and liquidate
15 the security for the loan.
16 "(f) Upon termination of a loan guaranteed under
17 this subchapter the holder shall liquidate the security for
18 the loan and submit a final accounting to the Secretary.
19 "(g) The Secretary may not acquire any collateral for
20 any loan guaranteed under this subchapter.
21 "(h) The Secretary may provide by regulation for the
22 assumption of a loan to a veterans' small business concern
23 guaranteed under the subchapter by a purchaser of an in-
24 terest in the small business concern. Except as authorized
25 by the Secretary, loans guaranteed under this subchapter

1 must be paid in full upon sale of any interest in the busi-
2 ness by a veteran whose eligibility was used to obtain the
3 loan.".

4 **SEC. 12. REVOLVING FUND.**

5 Section 3749 of chapter 37 is amended—
6 (1) in subsection (b)—
7 (A) by striking out "and direct loan"; and
8 (B) by striking out "other than" and in-
9 serting in lieu thereof ", including"; and
10 (C) by inserting a comma after "ex-
11 penses";
12 (2) in subsection (c)(2), by striking "sub-
13 chapter," and all that follows through "sold." and
14 inserting in lieu thereof "subchapter."; and
15 (3) in subsection (e), by striking "financial
16 assistance" and inserting "loan guarantees".

17 **SEC. 13. INCORPORATION OF OTHER PROVISIONS BY THE**
18 **SECRETARY.**

19 Section 3750 of chapter 37 is amended by striking
20 "made or" both places it appears.

21 **SEC. 14. FEES AND SALE OF LOANS.**

22 Subchapter IV of chapter 37 is amended by redesig-
23 nating section 3751 as 3753 and inserting after section
24 3750 the following new sections:

1 **"§ 3751. Fees**

2 "(a) A funding fee equal to 2.0 percent of the total
3 loan amount shall be collected from each veteran small
4 business concern obtaining a small business loan guaran-
5 teed under this subchapter.

6 "(b) A loan guaranty fee of 2.0 percent of the total
7 loan amount shall also be remitted for each veteran's small
8 business loan guaranteed under this subchapter. This fee
9 may be paid by either the small business concern or the
10 lender.

11 "(c) The amount of the fees collected under this sec-
12 tion may be included in the loan and paid from the loan
13 proceeds. No loan may be guaranteed under this sub-
14 chapter until the fees payable under this section have been
15 remitted to the Secretary.

16 **"§ 3752. Sale of loans**

17 "(a)(1) Any loan guaranteed pursuant to this sub-
18 chapter may be sold by the lender and by any subsequent
19 holder. Loans may be sold as whole loans or the portion
20 of the loans guaranteed by the Secretary (hereafter in this
21 section referred to as the 'guaranteed portion') may be
22 sold separately by the lender and by any subsequent hold-
23 er.

24 "(2) Servicing of the loans (including servicing of the
25 guaranteed portion where such portion is sold separately)
26 may be transferred to any servicer approved by the Sec-

1 retary, pursuant to regulations which the Secretary shall
2 prescribe.
3 "(b)(1) Notwithstanding any other provision of law,
4 the Secretary may, upon such terms and conditions as the
5 Secretary deems appropriate, issue or approve the issu-
6 ance of, and guarantee the timely payment of principal
7 and interest on, certificates or other securities evidencing
8 an interest in a pool approved by the Secretary with re-
9 spect to loans guaranteed under this subchapter, which
10 may consist either entirely of whole loans or entirely of
11 the guaranteed portion of such loans.
12 "(2) The Secretary's liability pursuant to the cer-
13 tificate guaranty in a pool consisting of whole loans shall
14 be limited to the timely payment of principal and interest
15 on the guaranteed portion of the loans which compose the
16 pool. In the event that a loan in such a pool is prepaid,
17 either voluntarily or as a consequence of default, the Sec-
18 retary's liability pursuant to the certificate guaranty shall
19 be reduced in proportion to the amount of principal and
20 interest the guaranteed portion of such prepaid loan rep-
21 resents in the pool.
22 "(3) In the event that the Secretary pays a claim
23 under a guaranty issued under this subsection, the Sec-
24 retary shall be subrogated fully to the rights satisfied by
25 such payment.

1 "(4) No Federal or State law shall preclude or limit
2 the exercise by the Secretary of any ownership rights in
3 the guaranteed portion of loans constituting a pool against
4 which certificates described in paragraph (1) are issued.
5 "(c) Nothing in this subchapter shall be interpreted
6 to impede or extinguish the right of the small business
7 concern or the successor in interest to such small business
8 concern to prepay (in whole or in part) any loan guaran-
9 teed pursuant to this subchapter.".

10 **SEC. 15. TERMINATION OF PROGRAM.**

11 Section 3753 of chapter 37, as redesignated by sec-
12 tion 14 of this Act, is amended—
13 (1) by striking "financial assistance" and in-
14 serting "loan guarantees"; and
15 (2) by striking "1986" and inserting "1998".

16 **SEC. 16. CONFORMING AMENDMENTS TO TABLE OF SEC-**
17 **TIONS.**

18 In the table of sections for subchapter IV of chapter
19 37:
20 (1) The item relating to subchapter IV is
21 amended to read as follows:

"SUBCHAPTER IV—SMALL BUSINESS LOAN GUARANTEES".

22 (2) The item relating to section 3742 is
23 amended to read as follows:

"Sec. 3742. Small business loan guarantee program.".

1 (3) The item relating to section 3744 is
2 amended to read as follows:

"Sec. 3744. Automatic guaranty.".

3 (4) The item relating to section 3748 is
4 amended to read as follows:

"Sec. 3748. Liquidation and claims.".

5 (5) Strike the item relating to section 3751 and
6 insert the following:

"Sec. 3751. Fees.
"Sec. 3752. Sale of loans.
"Sec. 3753. Termination of program.".

7 **SEC. 17. EFFECTIVE DATE.**

8 The amendments made by this Act shall take effect
9 October 1, 1993.

SECTION BY SECTION HIGHLIGHTS

VETERANS' SMALL BUSINESS LOAN ACT OF 1993
(Discussion Draft 4/19/93)

SECTION 1 -- Provides short title to be Veterans' Small Business Loan Act of 1993.

SECTION 2 -- Provides that amendments or repeals cited in the Act refer to title 38, United States Code.

SECTION 3 -- Renames Subchapter IV of chapter 37 from Small Business Loans to Small Business Loan Guarantees.

SECTION 4 -- Amends Section 3741 to define the term "eligible veteran" as:

-- a disabled veteran;

-- a veteran having active duty Vietnam era or Persian Gulf War service totaling at least 90 days; or

-- a veteran, other than the above, having active duty service at any time after May 7, 1975, for more than 180 days.

SECTION 5 -- Renames Section 3742 of chapter 37 from Small business loan program to Small business loan guarantee program. Section 5 also:

-- Deletes the authority for direct business loans;
-- Reduces the maximum loan amount VA may guarantee to $100,000;
-- Reduces VA's guaranty liability to 50% of the maximum loan amount;
-- States that assistance to a small business is limited to a loan guaranty;
-- Provides for second loan where first loan was less than maximum or Secretary's obligation does not exceed $ 50,000.
-- Limits veterans entitlement to loan for one business only; and
-- Removes Secretary's authority to assume loan payment in cases of default.

SECTION 6 -- Makes conforming amendments to note assistance is only a loan guaranty;

and -- Provides that an individual is not personally liable to the government for any claim except in cases of fraud, misrepresentation or bad faith to obtain the loan.

SECTION 7 -- Provides that only supervised lenders or lenders approved by SBA to close loans on an automatic basis may make VA guaranteed loans.

HIGHLIGHTS VETERANS' SMALL BUSINESS LOAN ACT OF 1993
page 2

SECTION 8 and SECTION 9 -- Makes conforming amendments to eliminate reference to direct loans in sections 3745 and 3746.

SECTION 10 -- Limits lender participation to lenders identified in section 3744.

SECTION 11 -- Eliminates the prior preference for disabled veterans in the extension of financial assistance;

-- Adds new liquidation and claim procedures;
-- Requires 90 day notice to Secretary of default; and
-- Defines VA's claim liability as the total guaranteed indebtedness of the small business less the value of any collateral, equity or assets, including good will.

SECTION 12 -- Provides that the Small Business Loan Revolving Fund will fund all operations under this subchapter, including administrative expenses. Existing law excludes paying administrative expenses.

SECTION 13 -- Makes conforming amendments to section 3750.

SECTION 14 -- Adds new section 3752 to provide a 2% funding fee and a 2% loan guaranty fee that may be paid by the lender or the small business concern.

-- Provides for inclusion of fees in the loan amount;
-- Loans could not be guaranteed until receipt by the Secretary of such fees; and

-- Adds new section 3753 to permit lenders of VA loans to guarantee business loans to sell such loans in the secondary market or to split the loans according to the VA guaranty and to sell the guaranteed portion in the secondary market.

-- Authorizes the Secretary to issue, approve the issuance of, and guarantee the timely payment of principal and interest on certificates or other securities supported by a pool of loans consisting solely of the guaranteed portion of the indebtedness.

-- Permits the Secretary to attach a similar guaranty to a pool of loans that includes the unguaranteed portion of the loans and limits liability to the guaranty.

SECTION 15 -- Provides a program expiration date of September 30, 1998.

SECTION 16 -- Makes conforming amendments to table of sections for subchapter IV of chapter 37.

SECTION 17 -- Establishes an effective date of October 1, 1993.

May 13, 1993
COMMITTEE ON VETERANS' AFFAIRS
SUBCOMMITTEE ON HOUSING & MEMORIAL AFFAIRS
HONORABLE DAN BURTON

THANK YOU, MR. CHAIRMAN. I LOOK FORWARD TO TODAY'S DISCUSSION OF A DRAFT BILL, WHICH YOU HAVE WORKED VERY HARD ON, ENTITLED THE"VETERANS' SMALL BUSINESS LOAN ACT OF 1993."

WHEN I HEARD THAT A HEARING HAD BEEN SCHEDULED TO CONSIDER THE CREATION OF A SMALL BUSINESS LOAN PROGRAM FOR VETERANS, I HAD MIXED FEELINGS ABOUT THE IDEA. SINCE COMING TO CONGRESS, I HAVE HAD VETERANS COME TO MY OFFICE LOOKING FOR HELP TO START A NEW BUSINESS. IN MOST CASES, THEY WERE UNABLE TO GET A LOAN FROM THE SMALL BUSINESS ADMINISTRATION. IT WAS VERY DIFFICULT FOR ME TO TELL THESE VETERANS THAT THE GOVERNMENT HAD NO WAY TO HELP THEM.

AT THE SAME TIME, I AM CONCERNED ABOUT CONSIDERING NEW V.A. PROGRAMS AT THIS POINT IN TIME. LAST YEAR, MANY GOOD BILLS WERE BROUGHT BEFORE THIS SUBCOMMITTEE. UNFORTUNATELY, WE DID NOT HAVE THE MONEY TO FUND THEM. IN ADDITION, I HAVE BEEN TOLD BY MANY VETERANS THAT WE ARE DOING TO TOO MANY THINGS WITHIN THE DEPARTMENT OF VETERANS AFFAIRS RIGHT NOW, AND NONE OF THEM VERY WELL. I THINK MANY OF THESE VETERANS WOULD BE VERY SATISFIED IF WE FULLY FUNDED EXISTING V.A. PROGRAMS. SO, I WANT TO LOOK VERY CAREFULLY AT ANY POSSIBLE NEW V.A. PROGRAMS. I DO NOT WANT TO TAKE AWAY ANY FUTURE FUNDS FROM EXISTING VETERANS' PROGRAMS THAT ARE ALREADY UNDERFUNDED.

WITH THAT BEING SAID MR. CHAIRMAN, I YIELD BACK TO YOU.

Testimony of Frederick O. Terrell

Managing Director, The First Boston Corporation

Before the

Subcommittee on Housing and Memorial Affairs

George E. Sangmeister, Chairman

Hearing on

The Department of Veterans Affairs Small Business Loan Program

May 13, 1993

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to share my thoughts on the Department of Veterans Affairs contemplated small business loan program.

My name is Frederick O. Terrell and I am a Managing Director with The First Boston Corporation. I have been with the firm since 1983. First Boston is a full-service international investment banking firm serving both suppliers and users of capital around the world. Through its wholly owned subsidiaries – The First Boston Corporation in the Americas, Financiere Credit Suisse - First Boston in Europe and the Middle East, and CS First Boston Pacific in the Asia/Pacific Region – CS First Boston provides comprehensive financial advisory services and develops innovative financing approaches for a broad range of entities. The firm employs its own capital resources to trade and underwrite securities and to engage in merchant banking and other principal transactions.

In my current capacity I serve as co-head of the firm's Conventional Issuance and Trading Group which has responsibility for delivering mortgage and asset-related investment banking services to banks, thrifts, federal agencies and to other entities operating within the broad financial institutions arena. In this capacity, special product emphasis is placed on securitization - the process of creating financial instruments from the pooling of assets with what are often very dissimilar cash flows. It is an area for which First Boston has served as a pioneer - creating the first Collateralized Mortgage Obligation (CMO) for Freddie Mac in 1983 and the First Asset-Backed Security (ABS) for the then Sperry Lease Finance Corporation in 1985. During the last several years I have also had the responsibility of leading First Boston's federal government finance efforts as the firm became actively involved with the federal government's program to liquidate certain assets from the balance sheets of its agencies and departments. As an outgrowth of this effort First Boston currently serves as lead manager for the Department of Veterans Affairs Vendee Loan Securitization Program through which the mortgage market's first full faith and credit REMIC Certificates were issued last year.

First Boston as a firm, and I personally, have spent considerable time and resources working with other similar programs. Among its wide variety of securitization activities within the federal agency sector, the firm also currently acts a lead manager for two Small Business Administration (SBA) Securitization Programs, one on behalf of the Small Business Investment Companies (SBICs and SSBICs or MESBICs) and the other, the Section 504 Program, on behalf of Community Development Corporations (CDCs) across the country.

The comments that follow represent an analysis of the proposed VA program, relative to the small business lending programs which are already in place. Examining and understanding the existing programs is one method of determining the need for an additional federal plan, and designing that plan if such a need exists.

The Existing Programs

The program which already exists and which is most similar to the proposed VA plan is the Small Business Administration's (SBA) 7a program. This program was created to assist small businesses in obtaining capital for equipment purchases and upgrades, real estate, start-up funding and inventory buildup. The SBA backs a portion of the 7a loans with the "full faith and credit" of the federal government. The SBA guarantee covers 90% of the portion of each loan under $155,000 and 80% of the portion between $155,000 and the maximum of $750,000. The average loan size is about $250,000.

The terms of the SBA loans include a 2% fee imposed upon the borrower which would typically be subtracted from loan proceeds. The interest rates are either fixed or adjustable and tend to be competitively negotiated between the borrower and the issuing financial institution. The average interest rates on 1992 adjustable rate loans averaged 100 basis points above non-guaranteed loans. The maturities of loans issued under the program tend to be quite long (three to four times), relative to private bank commercial and industrial loans. These extended maturities keep payments low. This is critical because the policy goals include not only getting the small business person started, but keeping the person in business; lower periodic payments make that possible.

The Secondary Market

The role played by First Boston and other Wall Street firms is the maintenance of a secondary market in the guaranteed portion of the loans. Market makers directly access lenders to buy individual loans or loan pools. This mechanism puts cash back into the hands of the lenders, who can then turn around and originate more guaranteed loans. The loans are attractive to investors because they have no credit risk, they have attractive yields, and the prepayments are tolerable given the highly leveraged nature of a typical borrower.

The secondary market for loans made under the 7a program has become institutionally dominated. Large lenders and loan pooling services have reduced the role available for smaller participants. Every year since pooling has begun, overall loan issuance has increased. In the secondary market, pooling volume is growing much more rapidly than

individual loan sales and is expected to continue in this manner due to the availability of capital and investor demand. In 1992, the $2.0 billion of pooled loans accounted for approximately 80% of all guaranteed program loans sold in the secondary market, up from 66% in 1991, 50% in 1990, and 44% in 1989. The growth trend is magnified by the increase in overall dollar volume of guaranteed loans. Aggregate issuance has increased 90% from the 1990 sum of $2.9 billion to the 1992 sum of $5.5 billion.

The VA Proposal

The Subcommittee should carefully analyze the terms of the VA proposal relative to the goals, objectives and accomplishments of the programs already in place. The terms of the VA initiative provide for a 50% guaranteed/ 50% first loss business loan with a maximum balance of $100,000 per loan. The veteran will be required to pay a 2% funding fee and a 2% loan guarantee fee. Both fees appear to be financeable, i.e. they can be added onto the balance of the loan. The goals of the program are to provide much needed financing to veterans who aspire to own their own businesses upon leaving the service. This is intended to ease the impact of the downsizing of the military, and bolster employment in general.

It is uncertain that lenders will have as great an incentive to lend under these circumstances, as they currently do with the SBA program. This is true because the SBA loans are 80% to 90% guaranteed, and the VA proposal provides for only a 50% guarantee. Lenders would surely extract a premium in interest rates in those cases where they chose to lend. Moreover, veterans in search of government guaranteed small business loans could approach an existing SBA lender and get a larger loan, at a lower rate, with fewer points. The SBA's $750,000 maximum balance might give borrowers a level of comfort that they won't outgrow the VA's program. Lastly, the relatively small size of the securitizable portion of the loans (50% of $100,000), will lead to a smaller secondary market for the paper. The combination of these three sets of incentives does not bode well for the proposed program.

Suggestions

Given that there is a federal agency and program in place with similar policy goals, it would seem to make sense that an effort be made to link prospective VA borrowers with SBA lenders. Instead of creating a duplicate infrastructure to cope with the issues of a guarantor, the Department of Veterans Affairs could establish a liaison who educates veterans about the risks and rewards of business ownership, and who brings business to the doors of willing lenders. The program would promote the desired goals, and work

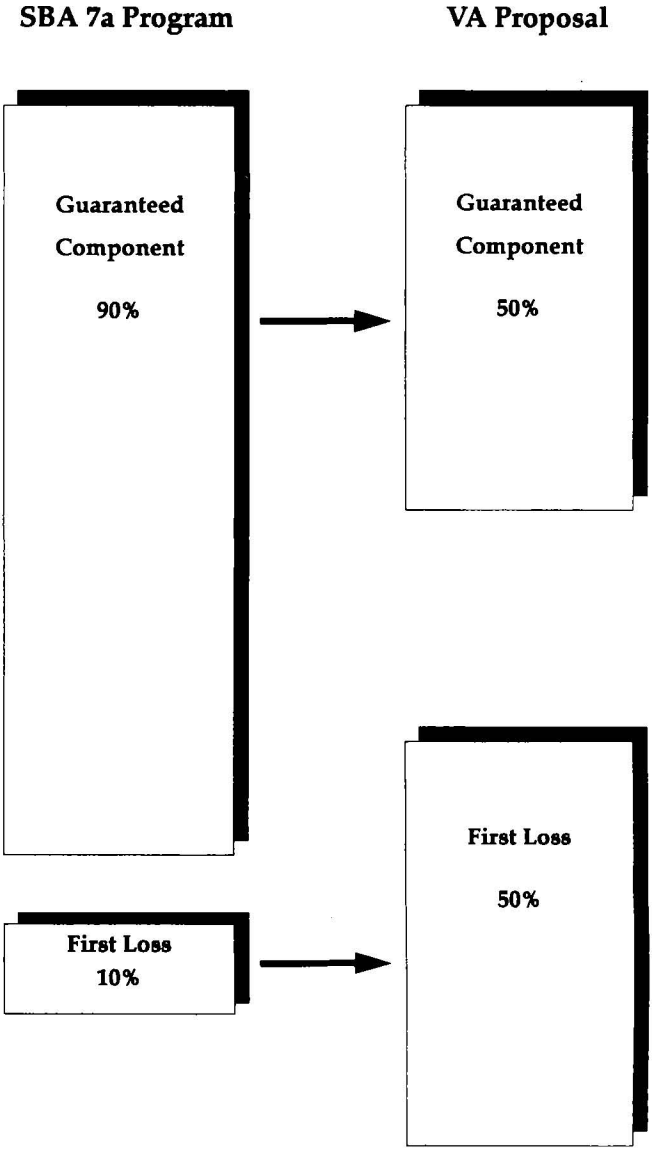
within the existing framework. This would also be an immediate method of reaching deserving veterans; developing a primary and secondary market can be very time consuming. Moreover, the additional lending under the 7a program would add liquidity to the program and make the secondary market more efficient. This should lead to a reduction in rates charged by lenders.

The VA, in its role as liaison, would be well suited to process applications, create standardized documentation of program eligibility, and raise awareness surrounding the program. This consciousness raising and additional revitalization of the existing programs could help to ensure the consistency of funding for the program. Recent setbacks suffered by the incumbent administration in providing funding for a program as popular as small business lending could be offset by the power of an agency like the Department of Veterans Affairs. A number of decisions will have to be made to assess the political palatability of such a proposal, but it would certainly be a lower cost method of achieving the desired results.

Thank you once again for taking the time to hear our thoughts on the proposed program. There is no questioning the value of the goals of the program. First Boston will take the necessary steps to encourage the success of the plan, regardless of the form it takes.

Department of Veterans Affairs

Proposed Small Business Lending Program



Statement of

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before the

Subcommittee on Housing and Memorial Affairs
of the
Committee on Veterans' Affairs

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Mr. Chairman and members of the Subcommittee:

My name is Steve Rohde. I am a Principal in the consulting firm of Hansen, McOuat, Hamrin & Rohde, Inc.. I am based in Washington, D.C., and I am in charge of the firm's activities in assisting states, cities, federal agencies and other organizations in the development and implementation of cutting edge development finance programs.

I have been asked to comment on a proposal that was developed last year by the Department of Veterans Affairs for a veterans small business loan initiative for loans of $100,000 or less. Let me first say that, in general, I believe that the objective of developing tools that can serve as a complement to the SBA loan guarantee program, especially for small loans, has substantial merit. However, for a variety of reasons, I have doubts about the effectiveness of the approach proposed by the Department last year.

The intent of the proposed program is to provide a new tool for banks to be able to make small business loans which have a greater degree of risk than a conventional loan, thereby resulting in loans that otherwise would not be made. For reasons I will explain later, there is a serious question as to whether or not the program would, in practice, prove attractive to banks as a vehicle for making riskier loans. However, before addressing the issue of how effective a tool the program would be for facilitating riskier loans, it may be useful to provide some observations regarding reasonable expectations for any small business guarantee program focused on the small loan niche.

The press release issued on October 28, 1992 by the Department of Veterans Affairs projected that over a five year period, the program would generate $15.9 billion in new lending, creating 1,000,000 jobs. In my view, even if the program proved to be an attractive vehicle for banks, such a projection would, nevertheless, have to be considered overly optimistic to an extreme degree. For a program focused on loans of $100,000 or less, designed to reasonably increase the capacity of banks to make riskier loans, there is no evidence to support that type of loan activity projection. Indeed, even if the SBA guarantee program did not exist, and even if the proposed program were expanded to make non-veterans eligible, realistically the loan activity and job creation numbers would be only a small fraction of what was projected.

Thus far, in discussing the projections, I have assumed that the proposed structure would prove to be an attractive vehicle for banks to make riskier loans. However, there is substantial reason to doubt whether the proposed program, as structured, would work that way in practice. Although not stated explicitly in the Department's October 1992 press release, presumably the reason for the reduction in the guarantee percentage to 50% (compared to an 85% or 90% guarantee in the SBA program) is to enable the Department to make the program nonbureaucratic by relying more on the bank's review, justified because the bank would be taking 50% of the risk. While making the program nonbureaucratic would be attractive to banks, having the bank take 50% of the risk is likely to result in banks being conservative in avoiding risk, in a way which sharply limits the number of loans made under the program that they would not do without the program.

The basic problem is that by using the loan-by-loan guarantee approach of the proposed program, there is an inherent tradeoff between making the program more attractive to banks by reducing bureaucracy through lowering the guarantee percentage, and making the program less useful to banks because the lowered guarantee percentage increases the bank's risk. If the Congress wishes to consider a new approach focusing on the establishment of a nonbureaucratic program which at the same time gives banks a highly effective tool for risk management, there is a proven, effective approach, pioneered at the state level, which uses a portfolio insurance mechanism instead of a loan-by-loan guarantee. Moreover, it is likely that this approach could be implemented as a national program with virtually no cost to the federal government.

The program is known as the Capital Access Program, and was first implemented in 1986 in the State of Michigan. In my former capacity with a state agency in Michigan known as the Michigan Strategic Fund, I was responsible for the design of this program, and for supervising its implementation until I left the Michigan Strategic Fund in October 1991.

The program provides banks with a flexible and extremely nonbureaucratic tool to make business loans that are somewhat riskier than a conventional bank loan, in a manner consistent with "safety and soundness" bank regulation. The program helps make possible private market transactions in which the bank exercises its own judgement, and the borrower obtains access to bank financing which it would otherwise not be able to obtain.

The banking industry in Michigan has enthusiastically embraced the program, using it to help finance more than 2,000 Michigan businesses. Banks representing about 80% of statewide commercial banking assets have actually made loans under the program. The program has grown dramatically in usage year by year, with more that 500 companies receiving financing in 1992 alone, and a current pace for 1993 which would finance about 700 companies this year alone.

In Michigan, the Capital Access Program has served as a good complement to the SBA 7(a) program. It has been especially effective in assisting banks to provide small loans to small businesses. While loans have ranged from a low of $400 to a high of $1.7 million, the average loan amount has been about $50,000, and some 88% of the loans have been less than $100,000. Some 89% of the companies financed had annual sales of less than $1 million, with 56% of the companies having annual sales of less than $200,000, and 21% being start-ups.

As I have indicated, the key to the design of the program is its unique portfolio insurance concept. In this way it differs from the traditional loan-by-loan guarantee approach, such as guaranteeing 85% or 90% of each loan made in the SBA 7(a) program, or 50% of each loan made as in the program proposed last year by the Department of Veterans Affairs. By contrast, the Capital Access Program does not guarantee loans individually, but instead establishes a special reserve fund, separately earmarked for each participating bank, to cover future losses from the whole portfolio of loans that the bank makes under the program. While this reserve fund is owned and controlled by the Michigan Strategic Fund, its sole purpose is to cover losses that the bank might suffer on Capital Access Program loans. Each bank participating in the program has its own separate earmarked reserve fund.

Payments are made into a bank's earmarked reserve each time the bank makes a loan under the program. The borrower makes a premium payment of from 1 1/2% to 3 1/2% of the loan amount, the bank matches that payment, and then the Michigan Strategic Fund matches the combined total of the borrower's and the bank's payment. The bank is allowed to recover the cost of its payment from the borrower through the pricing of the loan, such as by increasing the interest rate or charging a fee. Any up-front premiums or fees can be financed as part of the loan.

If a bank makes a portfolio of loans under the program, it might have a reserve equal to, for example, 10% of the total amount of that portfolio. In such a situation, the bank could sustain a loss rate of up to 10% on that portfolio and still be completely covered against loss. This gives the bank the ability to absorb a substantially higher loss rate than it could tolerate on its conventional loans. However, the bank must still be prudent, since it is completely at risk for any losses that exceed the coverage provided by the reserve.

Because of this built-in incentive for prudence in the program's structure, there is no need for the Michigan Strategic Fund to play any role in reviewing or second guessing the bank's lending analysis. The bank decides whether or not and under what terms and conditions to make a loan, and files a one-page Loan Filing Form with the Strategic Fund within 10 days <u>after</u> a loan is made under the program.

Mr. Chairman, I would like to submit for the record a statistical summary of loan activity to date in Michigan, as well as a detailed program paper which provides a full description and discussion of how the program works.

Experience with the Capital Access Program in Michigan enables us to draw a number of key additional conclusions about the program, as follows:

1. The flexibility and lack of bureaucracy in the program has been a key to its attraction to the banking industry. Banks have been able to integrate the program into their normal lending processes. In other words, the program typically is a tool available to any commercial loan officer, as opposed to having to appoint a specialist to do Capital Access deals.

2. The lack of bureaucracy in the program has also made it quite cost effective for the state to administer. Essentially in Michigan the program has been implemented with one full-time professional.

3. Because the state's financial involvement and exposure is limited to the amounts of the matching deposits into the reserve funds, there is a high degree of leverage of the state's resources. The ratio of bank lending under the program to the amount of state deposits into the reserve funds has exceeded 22 to 1.

4. In Michigan, the program has served as a complement to, rather than a substitute for, the SBA 7(a) program. In part this is due to the Capital Access Program being used extensively by banks that have not used the SBA program. In addition, banks that are active in using the SBA program have also used the Capital Access Program extensively for different purposes than they use SBA, such as, for example, smaller loans and lines of credit.

5. The program has been used effectively by banks of all sizes, and loans have been geographically dispersed throughout all regions in Michigan. The program has been used effectively in the central cities, suburban areas and the rural areas of Michigan.

6. The loss rate under the Capital Access Program appears to be running about four or five times a normal bank loss rate. This is, in fact, very close to what we originally anticipated. The loss experience is indicative of the fact that these loans would otherwise not have been made by banks, because they are riskier than normal. The very good news from this experience is that banks have been able to take this extra risk and yet manage this risk effectively to keep losses well within the capacity of the program reserves to absorb.

What kinds of additional risk has the program enabled banks to assume? The most common type of risk, or weakness in a loan, that banks have used the program to offset is a collateral weakness. Other types of weaknesses frequently cited by bankers that the program is used to address include low net worth and the lack of significant historical track record (for example, the company may be a start-up or a very young company). Other risks that the program has been used to offset include, for example, uncertainty caused by rapid growth, weaker historical financials than normally acceptable, the need to lengthen the term to maturity to address cash flow issues, and financing a type of company which the bank normally views as too risky.

The success of Michigan's Capital Access Program has generated substantial attention across the country. At least six other states have now implemented the program, and several others are preparing to implement it. However, the impact of the tool could be increased dramatically if the program were implemented as a full fledged national program. Moreover, as I will discuss, the program's already impressive cost effectiveness could be substantially enhanced if implemented on a national level.

Instead of funding the government's contribution to the reserve fund through deposits in a separate deposit account at each bank, as is done by the states, the federal government could support a separate reserve account for each bank by using a federal full faith and credit guarantee up to the balance stated in the reserve account. Experience in Michigan suggests that for the foreseeable future, the cumulative amount collected by the government in fees

from the private sector on an overall program basis is likely to exceed the amount paid in claims, thus in effect resulting in the program paying for itself. For example, through the end of April 1993, with almost 7 years of experience in Michigan, the cumulative borrower/bank fees paid to the reserve funds has been about $3.7 million, with only $3.1 million paid out in claims.

Of course, for a national program, if losses turn out to be significantly higher than anticipated, the claims may in time exceed the amounts collected in fees. However, because of the unique portfolio insurance structure, with claims to be paid limited to the balance in the reserve account earmarked for the bank filing the claim, the potential exposure of the government is many times less than in a loan-by-loan guarantee approach. For example, extrapolating from the Michigan experience, I estimate that during the first 8 years of a full fledged national program, the program might assist banks to provide a total of $4.5 billion to some 80,000 businesses. Even if every one of these loans went bad (which obviously will not happen), the maximum ultimate net loss to the federal government would be limited to about $200 million.

Finally, it is important to point out that if the Congress wishes to consider a national Capital Access Program, the only way such a program can be effective is if eligibility is defined in a broad based manner. This is because each bank needs to have confidence that it will be able to build up a substantial portfolio of loans within a reasonable period of time. Thus, for example, the Capital Access Program is <u>not</u> a program that could be effectively implemented just for veterans. The program can be effective for veterans, but only if both veterans and non-veterans are eligible to participate.

I have appreciated the opportunity to provide this testimony, and would be happy to answer any questions from members of the Subcommittee.

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CAPITAL ACCESS PROGRAM

Introduction

The Michigan Strategic Fund's (MSF) Capital Access Program, launched in August 1986, provides banks with a flexible and nonbureaucratic tool to make business loans which are somewhat riskier than conventional bank loans, in a manner consistent with safe and sound bank regulations. The Capital Access Program can thus assist banks in expanding their markets and better serving their customer base, and can have an important positive impact on the creation of jobs and improving the effectiveness of Michigan's economy by supporting the growth and success of Michigan businesses.

As of this writing, the program has already assisted banks in financing over 1,900 companies. With more and more banks beginning to make substantial use of the program all the time, the number of companies financed under the program continues to increase dramatically each year. Loans have been made under the program for as small as $400 and as large as $1.5 million. The average loan is about $50,000.

From the bank's perspective, a central feature of the program is the flexibility of the program and its extremely nonbureaucratic administration. The bank has sole responsibility for deciding whether or not and under what terms and conditions to make the loan. To enroll a loan in the program, a one page form is sent to the MSF within 10 days <u>after</u> the loan is made.

From the borrower's perspective, the key feature of the program is that it provides access to financing that might otherwise not be available. Access to financing is often a crucial ingredient in enabling a business to prosper and grow.

From the MSF's viewpoint, a key feature of the program is the high degree of leverage of public resources -- a relatively small amount of MSF funds can generate a relatively large amount of bank lending. To date, the leveraging ratio of private to MSF resources being achieved by the program is 22 to 1, and it continues to increase.

This paper describes and discusses the program in some detail, and is intended to be helpful for descriptive purposes. The official legal document specifying program parameters is the Agreement entered into between the MSF and each participating bank.

Basic Concept of Program

Although the Capital Access Program is based on an insuring concept, it is fundamentally different from the traditional type of insurance or guarantee program, such as the SBA 7(a) program, which guarantees some percentage of a loan on a loan-by-loan basis. Instead, Capital Access is based on a portfolio concept.

If a bank participates in the Capital Access Program, a special reserve fund is set up to cover future losses from a portfolio of loans that the bank makes under the program. The special reserve is owned and controlled by the MSF, but it is earmarked in that bank's name. Thus, each bank participating in the program has its own earmarked reserve. A bank can withdraw funds from its earmarked reserve only to cover losses on loans made under the program.

Payments are made into a bank's earmarked reserve each time the bank makes a loan under the program. The borrower makes a premium payment, the bank matches that payment, and then the MSF matches the combined total of the borrower's payment and the bank's payment. The bank is allowed to recover the cost of its payment from the borrower, such as through a higher interest rate, up-front fees, or some combination. Up-front premium payments and fees can be financed as part of the loan.

The actual level of payments to be made into the reserve at the time of making any loan is determined by the bank, within certain parameters. At the minimum, the borrower pays an amount equal to 1.5% of the loan amount, the bank would match that with another 1.5%, and then the MSF would contribute 3%, for a total of 6%. At the maximum, the borrower contributes 3.5%, the bank another 3.5%, and the MSF 7%, for a total of 14%.

Thus, for any loan made under the program, an amount equal to anywhere from 6% to 14% of the loan amount is paid into the bank's earmarked reserve. After a bank has made a portfolio of loans under the program, it might have a reserve equal to, say, 10% of the total amount of that portfolio. In such a situation, the bank could absorb a dollar loss rate of up to 10% on that portfolio and still be <u>completely</u> covered against loss. A key feature of the program is that the <u>full amount</u> in the bank's total reserve is available as needed to cover any loss from any of the loans made under the program. If loans get paid off without loss, the funds stay in the reserve.

The earmarked reserve enables a bank to be more aggressive in making loans and expanding its market. However, if a bank's loss rate were to exceed the coverage provided by the reserve, the bank would be at risk for that excess loss. Thus, there is a built-in incentive for a bank to be prudent.

Nevertheless, since the reserve would enable a bank to withstand a substantially higher loss rate than it could tolerate under its conventional loan portfolio, the program enables a bank to prudently make "almost bankable loans". For example, these loans might be loans to companies with good management and a good direction, but for one reason or another, such as lack of adequate collateral, lack of sufficient track records, lack of sufficient net worth, or other reasons, can't quite qualify for a conventional bank loan.

Because the program is structured to provide a built-in incentive for the bank to be prudent, there is no need for the MSF to be involved in reviewing the bank's decision on the loan. The reserve is there for the bank to protect and use. The bank makes the loan and simply files a one page Loan Filing Form with the MSF within 10 days after the loan is made. Enrolling loans under the program is thus designed to work as essentially an automatic process. There is no processing delay, and virtually no paperwork.

Flexibility is a key characteristic of the program. It is completely up to the bank to determine how it wants to use the program. The bank sets its own criteria for determining whether to make the loan, determines what types of loans it wants to make under the program, and decides the interest rate, fees, term of maturity, collateral requirements (if any), and other conditions of the loan. Thus the market is allowed to work, and intelligent private sector decision making is facilitated. The loan can be short-term or long-term, fixed or variable rate, secured or unsecured, amortizing or balloon, term loan or line of credit, etc.

When filing a loan for enrollment under the program, the bank has the option of covering an amount under the program which is less than the full amount of the loan. This provides added flexibility, since borrower and bank premium payments would then be based on this smaller amount. For example, let's say that a bank makes a $100,000 loan under the program, but is convinced that under a worse case scenario the maximum possible loss on the loan would be $60,000. The bank could decide to specify a covered amount of $60,000 on the loan. In such an event the funds in the reserve could be used to cover the first $60,000 in principal loss on the loan, plus accrued interest, plus documented out-of-pocket expenses.

A key feature of the program is the flexibility it provides to enable a bank to work with a borrower after the bank has made a loan to the borrower under the program. After a loan has been made under the program the bank can subsequently recast it as often as may be desirable. The bank can extend the term of the loan, amend covenants, release collateral, etc., without having to obtain approval from the MSF, or even reporting the change to the MSF.

The bank also has the flexibility to refinance the loan, adding funds. Indeed, if the total amount of the refinanced loan does not exceed the covered amount of the loan as previously enrolled, no new borrower or bank premium payments need to be made into the reserve, and the fact of the refinancing does not even need to be reported. (Once a year, the bank may be asked to file a simple report with the MSF containing merely a list of the outstanding balance for each loan enrolled under the program). For example, if a $100,000 loan covered under the program has been paid down to $30,000, and then is refinanced back up to $100,000, then no new premium payments are owed. However, if the loan were instead refinanced up to $150,000, then premium payments would be owed on the incremental $50,000 above the $100,000, but only if the bank wanted to cover that additional $50,000 under the program.

Lines of credit are also treated with similar flexibility. In establishing a line of credit and filing it for enrollment, the amount of the loan, for the purposes of determining premium payments and the maximum covered amount, shall be the maximum amount that can be drawn against the line of credit. Banks could

use their normal approach, including informal arrangements as applicable, in establishing a line of credit. A line of credit, once established, could then be renewed each year, staying covered under the program, without new premium payments being required (unless the covered amount under the program is to be increased).

The collection and claims process is also designed to work in a routine, nonbureaucratic way. The bank simply uses its normal method for determining when and how much to charge off on a loan. At the same time that a bank charges off all or part of a loan, the bank files a one page Claim Form with the MSF, with payment to be handled in a prompt and routine fashion.

Because of the payments that need to be made into the reserve, a loan made under the Capital Access Program is likely to be a bit more expensive to the borrower than a conventional bank loan. The premium payments into the reserve are one-time, up-front payments, the costs of which can be financed. Thus the longer the financing stays on the books, the smaller is the increase in the borrower's effective interest rate. However, the transaction is still likely to be more expensive than a conventional loan. Thus, borrowers who can obtain conventional bank financing to meet their needs would normally be better off with such financing, and competition within the banking industry will work to steer such borrowers to conventional financing. From the perspective of borrowers, the central thrust of the Capital Access Program is that it can provide access to financing for many companies that otherwise might not be able to obtain bank financing to meet their needs. Moreover, financing under the Capital Access Program is likely to be much less expensive for a company than alternative non-bank sources of financing, if any are available.

It is important that prospective borrowers under the program understand that the loan is a private transaction between the bank and the borrower. While the program may assist a bank in being able to take more risk than normal, it is still the bank that is bearing the risk of the loan, and is responsible for the decision making.

Allocation of Funds - Long Term Intentions of MSF

In establishing the program in 1986, the MSF Board initially allocated $5 million of MSF funds to make matching payments to the reserve funds, which would support an estimated $100 million in lending by participating banks. The resolution establishing the program also included a strong statement of intent of the Board's long term intentions regarding the program. The resolution stated that the Board intended the program to be operated on a market driven basis, without limiting the aggregate amount of loans that can be made under the program, that the $5 million allocation was only an initial allocation, and that the Board expected to provide additional allocations at future times as needed to meet market demand.

In 1990, the MSF Board renewed its long term commitment to the program. With a little over $2 million of the original $5 million allocation having been used, the Board increased its allocation to the program by $9 million, for a total allocation of $14 million. This $14 million allocation should support about $300 million of bank lending under the program.

Even with continued dramatic expansion in the use of the program, the current allocation of funds should be sufficient to support bank lending under the program for a number of years into the future. This should enable banks to participate in the program with confidence that they will be able to build up a substantial portfolio of loans, and take maximum advantage of the portfolio insurance mechanism of the program, without fearing that the program will run out of money.

Eligible Loans and Borrowers

The fundamental thrust of the program is to make eligibility as broad based as possible so as to maximize the impact on Michigan's economy and to avoid second guessing private market decisions. The borrower can be a corporation, partnership, joint venture, sole proprietorship, cooperative or other entity, whether profit or nonprofit, which is authorized to conduct business in the State of Michigan.

The basic approach is to keep the program flexible so that each bank can use the program in a manner which best suits the needs of the bank and its customers. Keeping the program broad based also assists banks in building up a portfolio to take maximum advantage of the portfolio insurance effect, thereby making the program more attractive and effective. Moreover, the high degree of leveraging of public resources supports keeping the program broad based.

There are, however, a relatively small number of restrictions that are either mandated by statute or are necessary to protect the basic integrity and purpose of the program. These restrictions are described below:

1. *Business Purpose in Michigan* - The proceeds of the loan must be used for a business purpose within the State of Michigan. Generally, therefore, the program is geared to Michigan businesses. In the case of a company with multi-state operations, the key test is that the primary economic impact of the endeavor financed by the proceeds of the loan be in Michigan.

2. *Exclusion of Housing* - The MSF statute prevents the financing of "that portion of an endeavor devoted to housing". Thus the proceeds of the loan cannot be used for the construction or purchase of residential housing. However, this is interpreted to mean permanent housing. Thus, loans to motels or hotels or for the construction of motels or hotels are eligible.

3. *Passive Real Estate Ownership* - The loan cannot be used to finance passive real estate ownership. Passive real estate ownership would occur if a company were to buy land or buildings simply as an investment, without developing or improving the real estate in any way, and without intending to use it for its own business operations.

   It is important to stress, however, that except for the restrictions against passive real estate ownership and housing discussed above, the program can be used for real estate financing. For example, the program can be used to assist a company to finance the acquisition of land or buildings intended to be used in the business operations of the company.

In addition, the program can be used to finance the activities of a developer or builder in acquiring real estate for developing or in constructing or renovating a building. In the case of a loan to a developer for construction or renovation financing, the loan under the program should be intended to cover the period through the construction or renovation phase. The permanent financing can also be included, if the borrower will be the company that will use the real estate for its own business operations.

4. ***Refinancing Prior Debt Which is Not in Program*** - A bank is not permitted to take an existing loan on its books (or on the books of an affiliate) which is not in the program and simply refinance it, without adding new money, and put the refinanced loan under the program. However, if a bank refinances an existing loan and adds new money by increasing the outstanding balance, it is permissible to cover under the program an amount not exceeding the amount of the new money. For example, if an existing loan, not under the program, has an outstanding balance of $100,000, and that loan is refinanced with a new balance of $150,000, the refinanced loan can be enrolled under the program, but the covered amount could not exceed $50,000.

5. ***Conflicts of Interest*** - A bank is not permitted to use the program for "insider" transactions. Insider transactions are defined to include a loan to an executive officer, director or principal shareholder of the bank, a member of the immediate family of such an executive officer, director or principal shareholder, or to a company controlled by any of these people. The basic definitions used in this conflict of interest prohibition tie in to basic terms used in the Federal Reserve's Regulation O, which the bank has to be familiar with in any event for their normal operations.

6. ***Size*** - There are no borrower size requirements or minimum or maximum loan sizes. It is recognized, of course, that the structure of the program will tend to focus the program on assisting small and medium-sized companies. However, no arbitrary limits are provided. It should be noted, however, that the maximum amount to be paid by the MSF into a bank's earmarked reserve in connection with any one borrower shall be $150,000 in any three year period, unless the MSF have approved, in writing, a greater payment. With the MSF making payments of between 3% and 7% of the loan amount, a $150,000 contribution would support a loan of anywhere from $2.1 million to $5 million, a large loan indeed. This provision does not mean that loans exceeding this level cannot be made, only that advance authorization must be obtained. This will assist the MSF in its own planning purposes.

Collection and Claims

The process for a bank getting reimbursed for losses on loans made under the program is intended to be as routine and nonbureaucratic as the process for enrolling loans under the program. The MSF simply relies on the bank to exercise reasonable care and diligence in its collection activities. If a loan gets into trouble, the program calls for the bank to determine when and how much to charge

off on an enrolled loan in a manner consistent with the bank's normal method for making such determinations on its conventional business loans. A bank would file a claim under the program at the time it charges off all or part of a loan. The claim may include the full amount of principal charged off, plus accrued interest, plus out-of-pocket expenses. (If the amount of the loan that the bank covered under the program is less than the amount of principal charged off, then the amount of principal and accrued interest included in the claim shall not exceed the principal amount covered under the program, plus accrued interest attributable to such covered principal amount).

In keeping with the extremely nonbureaucratic nature of the program, the Claim Form submitted by the lender to the MSF is only a half-page form. The program provides for prompt and routine payment.

The program is structured so that when the bank makes a loan and then enrolls it in the program, the bank is automatically making a small number of representations and warranties to the MSF that the loan complies with program requirements. If the bank later suffers a loss on that loan and properly files the claim for, the only grounds for denial of the claim would be if the representations and warranties made by the bank at the original time of the enrollment of the loan were known by the bank to be false at the time the loan was filed for enrollment.

The claim process allows a bank to recover its loss at the time it recognizes the loss, prior to having to exercise its collateral rights or other legal remedies in connection with the loan. However, the bank would be expected to continue to exercise its collateral or other rights in a manner such as it would do for a conventional bank loan. If there were a subsequent recovery from the exercise of such rights, so that the amount of loss ultimately were less than the amount for which the bank had been reimbursed from the earmarketed reserve, the bank would put the relevant amount of the recovery, net of out-of-pocket expenses, back into the earmarked reserve. This is similar to the process that a bank would follow in putting recoveries on conventional loans back into the bank's internal loan loss reserve.

As described above, the intent of the program is for the bank to be fully responsible for collection activities and for the MSF to stay out of the bank's way. However, as a safeguard against the extreme situation where a bank is abusing the intent of the program by ignoring its obligation to exercise reasonable care and diligence in its collection activities, the MSF will reserve for itself, in limited circumstances and as a last resort, the right to be subrogated to the rights of the bank. The subrogation would apply to any collateral, security or other right of recovery, in connection with a loan, which has not been realized upon by the bank. This provision could only take effect after the bank has filed a claim and has had its loss fully covered. It is hoped that the MSF will never have to exercise this right of subrogation.

Maintenance of the Reserve Fund

A central concept of the program is that the MSF owns the funds in the bank's earmarked reserve, but that these funds are legally dedicated solely to cover losses on loans made by the bank under the program. Legally, the MSF actually pledges the funds in the reserve fund to be available to pay claims on loans under the program.

For administrative convenience for both the MSF and the bank, and to provide an extra benefit to the participating bank, it is the plan of the MSF to open up an account at the bank, and deposit the monies in the bank's earmarked reserve right at the bank. The plan, as it has been implemented, involves establishing a money market deposit account in the MSF's name at the bank's published rate of interest.

It should be pointed out that although the above procedure is consistent with the full intent of the MSF, and there are no plans to do otherwise, the legal Agreement between the bank and the MSF does not bind the MSF to maintain the funds in a deposit account at the bank. Thus, for example, if a bank abuses the intent of the program, the MSF will have the flexibility to close that deposit account and deposit the monies in the reserve elsewhere. However, this wouldn't change the legal status of the reserve as dedicated solely to cover losses from loans that the bank makes under the program. Moreover, in the event that the MSF does not deposit the funds in an account at the bank, the funds may be invested or deposited only in: 1) direct obligations of the United States government or the State of Michigan, or in obligations the principal and interest of which are unconditionally guaranteed by the United States or the State of Michigan, or 2) a deposit account at a federally insured depository institution.

Half of the interest earned on the funds in the bank's earmarked reserve will stay in the reserve, to help build it up. The MSF is authorized to withdraw the other half of the interest for use by the MSF for whatever use the MSF Board determines.

Although the MSF technically owns the funds in the reserve, it is intended and expected that banks will develop a proprietary interest in the reserve. The reserve earmarked for a bank takes on the character of an off balance sheet asset of the bank, which enables it to be more aggressive in its lending activities. The bank controls the amounts of payments going into the reserve and the reserve is reduced only when the bank suffers a loss on a loan made under the program. The program rewards good performance, in that as loans are successfully paid off, the funds stay in the reserve, and actually increase over time through the earning of interest. However, if at some point in the future the bank were to completely drop out of the program, and after all of the loans previously made had been paid off, the MSF would ultimately be able to withdraw the funds from the reserve.

Bankers sometimes ask why the bank wouldn't be able to get back some or all of the funds from the reserve in the event that they have dropped out of the program and the loans have been paid off. The primary answer is that a key provision in maintaining the structural integrity of the program is that the bank can only gain access to the funds in their earmarked reserve to cover losses on loans made

under the program. If a bank knew that it could ultimately withdraw funds from the reserve after dropping out the program, this might create an incentive for the bank to put conventionally bankable loans under the program, because the bank might reason that it will ultimately get the money back anyway. By contrast, if the only way that a bank can gain access to the funds in the reserve is to cover losses from its program loans, the only way that a bank can ultimately get any advantage from the program is to use it for its intended purpose, as a flexible tool to enable the bank to expand its markets by taking more risk than it otherwise could take.

The program contains a formula for addressing the effective dropping out of the program by the bank. If for a consecutive 24 month period the amount in the reserve fund continuously exceeds the outstanding balance of all of the bank's enrolled loans made since the beginning of the program, the MSF is authorized to withdraw any such excess to bring the reserve down to an amount equal to 100% of the outstanding balance. As a practical matter, this formula would only come into play for a bank that has effectively dropped out of the program. Even if a bank has been inactive for a long period, if it begins making loans during the 24 month period, the aggregate outstanding balance would generally quickly exceed the reserve. The formula is thus intended to give the MSF the ability to withdraw funds from the reserves earmarked for banks that have effectively dropped out of the program, but to do it in a manner that in no way jeopardizes the protection that the reserve provides for any loans still outstanding.

Early Stage Incentives

How does a bank proceed in the early stages of its participation in the program, before a substantial reserve has been built up? Many banks will understandably have a tendency to be rather cautious initially. As the reserve begins to build up, and as the bank gains more experience under the program, the bank may gradually evolve to a more aggressive posture, expanding its margins that much further.

Even if a bank is unfortunate enough that one of its early loans in the program gets into trouble, it is likely to be some time before the loan actually defaults, and by that time hopefully the bank will have a portfolio of loans and have built up an adequate reserve. Nevertheless, other things being equal, there is some extra risk attached to these early loans made before a substantial reserve has built up.

Thus, in order to assist a bank to build up the reserve more rapidly and to address risk issues in the early stages of a bank's participation in the program, two special features have been included in the program. The first special feature applies to the first $2 million of loans that a bank makes under the program. This feature provides that the MSF will contribute a greater portion to the reserve. While the minimum and maximum payments for the borrower and the bank would remain the same, the MSF, rather than simply matching 100% for the combined total of the borrower and the bank, will instead contribute an amount equal to 150% of the combined total of the borrower and the bank. Thus, in the minimum case, the borrower contributes 1.5%, the bank 1.5%, and MSF 4.5%, for a total of 7.5%. In the maximum case, the borrower would contribute 3.5%, the bank 3.5%, and the MSF 10.5%, for a total of 17.5%. The first special feature is

designed to help build the reserve more rapidly, and to give the bank an extra incentive to begin to use the program.

The second special feature applies to the first $5 million of loans that a bank makes under the program. If one of those loans suffers a loss and at the time of the loss there is not enough in the reserve to fully cover that loss, the bank would initially be able to withdraw all of the amount in the reserve at the time of the loss, to cover the loss as much as possible. If the bank then continues making loans under the program and begins to build the reserve back up, the bank would be allowed to withdraw from the reserve at a subsequent time in order to fully cover the earlier loss. (The only restriction is that the amount subsequently withdrawn to cover the earlier loss cannot exceed 75% of the amount in the reserve immediately prior to such subsequent withdrawal). Thus, even at the beginning of its participation in the program, the bank has the comfort of a portfolio insurance effect, because it knows that if in the long term its losses are kept to a reasonable level, it will be fully protected against loss, and the bank won't suffer due to unlucky early losses.

The Process for a Bank of Sign Up for the Program

The MSF Board has approved a master form of Agreement to be separately entered into between the MSF and each bank that wishes to participate in the program. Entering into this Agreement does not commit a bank to make any loans under the program, but does spell out the full and official parameters that apply if a bank makes loans, and the obligations of the MSF and the bank under the program.

In its resolution approving the form of Agreement and authorizing the MSF staff to enter into such Agreements, the MSF Board stated that "it is the policy of the Board that such Agreements should be entered into with any depository institution, which has its principal office located in Michigan, that wishes to enter into such Agreement and that has sufficient experience and capacity to participate in the program, and that such depository institution should be considered to have such experience and capacity absent any credible evidence to the contrary".

Consistent with the entire approach to the program, the process for a bank to sign up to participate is thus being kept simple and routine. Staff is utilizing a half-page application form to obtain information on a depository institution's year-end commercial and industrial loans outstanding for each of the last three years. Absent any credible evidence that a depository institution lacks sufficient experience and capacity to participate in the program, staff is signing up lenders that wish to participate by entering into the Agreement.

Reliance on Banks to be Responsible

The Capital Access Program has been structured throughout to give banks the maximum possible freedom to make intelligent private sector lending decisions. Structural incentives are built into the program to promote program goals. Nevertheless it is also important to emphasize that the MSF is relying on the participating banks to be responsible. The ability of the MSF to keep the program simple and effective will be sustained if the participating banks attempt

to adhere not only to the letter of the program requirements, but also to the spirit and intent of the program.

In order to be able to implement the program in a fully nonbureaucratic manner, the MSF needs to be able to prevent the program from being abused. So that the MSF can move quickly if necessary to stop abuses, the MSF retains, in the legal Agreement entered into with each participating bank, the absolute discretion to terminate a bank from the right to make new loans under the program. (This wouldn't affect the status of loans already made under the program). Obviously the MSF's objective is to have as many banks as possible use the program successfully. Thus it is the MSF's intention to enforce this provision against a particular bank only if such bank has exhibited a pattern of abuse of the intent of the program. It is hoped that this authority will never have to be used.

As a bank begins to use the program, to assist the bank in particular cases it will probably be helpful for bank staff from time to time to seek informal clarifications regarding the objectives and intent of the program. The MSF staff will endeavor to provide quick responses. The MSF continues to be committed to making this program a model for government responsiveness and effectiveness, so that the program can have maximum benefit for banks, Michigan businesses, and the State.

STATEMENT OF

KEITH PEDIGO

DIRECTOR, LOAN GUARANTY SERVICE

DEPARTMENT OF VETERANS AFFAIRS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS

COMMITTEE ON VETERANS' AFFAIRS

HOUSE OF REPRESENTATIVES

May 13, 1993

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss the draft "Veterans' Small Business Loan Act of 1993." With me today is Mr. James P. Kane, Assistant General Counsel.

Mr. Chairman, I would first like to briefly review the history of VA small business loans. VA was authorized to guarantee business loans by the Servicemen's Readjustment Act of 1944. VA's guaranty was limited to $2,000 or, if the business loan was used to acquire real property, $4,000. At the peak of this program in 1951, VA guaranteed about 42,000 business loans. Unlike the home loan program, the amount of the business loan guaranty was not increased to keep up with inflation. In addition, more attractive loans became available through the Small Business Administration (SBA), and business loan entitlement was not extended to post-Korean conflict veterans. As a result, by the early 1970's the VA business loan program became virtually dormant. In Fiscal Year 1974, VA guaranteed only two business loans. Therefore, VA's business loan program was repealed by Public Law 93-569 effective December 31, 1974.

2.

Revised authority for a VA small business loan program was enacted by Public Law 97-72 on November 3, 1981. Although the statute authorized VA to guarantee or make small business loans, funds were never appropriated to implement the program. Therefore, the September 30, 1986, sunset for this program came without a single loan having been made or guaranteed. This draft bill would revive and revise that program.

The small business loan program proposed by the draft bill would provide loan guaranties; authority for direct business loans would not be included. Veterans who served on active duty for at least 90 days during the Vietnam era or Persian Gulf War, or other post-Vietnam era veterans who served for more than 180 days, and all service-connected 30 percent or more disabled veterans would be eligible for this program. The maximum loan amount would be $100,000, and VA's guaranty would be limited to 50 percent of the loan. This draft bill would permit the Department to guarantee loans for all the purposes contained in the now-expired law, including, among others, working capital and inventory.

At least 51 percent of the small business concern must be owned by eligible veterans. A veteran may use his or her entitlement for only one small business concern. A veteran whose entitlement has been used to obtain a loan guaranteed under this program may own a minority interest in another business receiving VA guaranteed financing, provided at least 51 percent of the business is owned by eligible veterans who have not previously used their entitlement.

Mr. Chairman, this draft bill would require that the small business concern pay a 2 percent loan funding fee. An additional 2 percent loan guaranty fee would be paid either by

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the small business concern or the lender seeking the guaranty as negotiated between the parties. The VA guaranty would not be issued until those fees are received by the Department.

All loans would be made on the automatic basis. VA would not review or approve any loan prior to closing. Only lenders subject to Federal or State examination and supervision, State agencies, or lenders approved as Certified or Preferred by SBA would be eligible to make loans under this proposed program.

In the event of default on a guaranteed loan, VA would pay a claim to the loan holder. This claim would be computed by taking into account the total unpaid indebtedness, the value of any security for the loan, and the equity interest of the business concern in any other assets. VA's authority under prior law to assume loan payments in cases of default would be repealed. VA would also be prohibited from acquiring any collateral for the loan.

Veterans will not have any personal liability to the Government following a default and claim payment by VA except in cases of fraud, misrepresentation, or bad faith. This nonliability is similar to provisions applicable to guaranteed housing loans obtained by veterans after December 31, 1989.

VA's authority to guarantee loans under this program would terminate on September 30, 1998.

This draft bill also encourages the establishment of a secondary market for veterans' small business loans by permitting VA to guarantee the timely payment of principal and interest on securities backed by a pool of VA guaranteed

4.

business loans. These loans would be pooled and sold by the private loan holder under terms and conditions established by VA.

Mr. Chairman, we are fully sympathetic with the objective of the draft bill; i.e., improving small business opportunities for veterans. However, before new policies are considered, we need to carefully examine two major issues.

First, the legislation is in conflict with the Federal Credit Reform Act of 1990. The bill establishes a revolving fund which is precluded by the Act. In addition, the Federal Credit Reform Act requires that a subsidy appropriation be established to cover the costs to the Government before any Federal loan guaranties are committed. Still another subsidy appropriation would be required to support administrative expenses. The bill does not address either of these subsidies.

Second, we believe the program structure would need to be carefully examined especially with respect to lenders' risk. The draft bill does not clearly state whether a lender would be able to require that the loans be secured. If the program were to be structured so that the loans have a 50 percent government guaranty but have no other security, lenders' funds would be at substantial risk. Accordingly, lenders would act with due diligence and generally make such unsecured loans only to the most creditworthy, experienced borrowers.

We cannot be certain, therefore, how many veterans would actually be able to meet a lender's strict criteria under such a program. We suspect that most of those who would qualify for such loans would already be able to obtain financing either through an SBA program or from conventional sources.

5.

If, however, the program were to be structured to serve a significantly larger number of veterans, we believe lenders would require that loans be secured, either by business or personal assets of the borrowers. If a lender has a 50 percent VA guaranty and also security equal to at least 50 percent of the loan amount, the risk to the lender would be minimal. Under such an arrangement, even with careful underwriting, we would expect a default rate at least equal to the 19 percent default rate on comparable SBA loans which have an average guaranty of 81 percent. Even in VA's home loan program, where the loans normally are fully secured by a first lien on the property and have a guaranty of at least 25 percent, the default rate is approximately 15.6 percent. We are aware that a home loan and a business loan are not equivalent. However, the home loan program is being used to illustrate that loans with high security could have a high default rate. Thus, the subsidy appropriation required to implement this program could be substantial.

For these reasons, we believe more study is needed before establishing a new program within VA.

This completes my statement, Mr. Chairman. I would be pleased to respond to any questions you or any of the members of the Subcommittee may have.

Testimony of John R. Cox
Director, Office of Financing
U.S. Small Business Administration
Before the
Subcommittee on Housing and Memorial Affairs
of the
Committee on Veterans Affairs
of the United States House of Representatives

Mr. Chairman and Members of this Committee, I am John Cox, director of the Office of Financing at the Small Business Administration. SBA Administrator Erskine Bowles was unable to be here today, but he asked that I review the Agency's small business loan program with regard to veterans. We have considerable experience in lending to these small business concerns.

The SBA provides financial assistance to veterans through both guaranteed and direct loans.

Our regular 7(a) guaranteed business loans are available to all veterans through local lending institutions. The maximum SBA share of a guaranteed loan is $750,000. Our direct loans are available only to Vietnam-era and disabled veterans who cannot obtain private-sector financing or guaranty assistance under our regular business loan program. Because funds are limited, the ceiling on direct loans is $150,000 per borrower, instead of the statutory ceiling of $350,000.

Our decentralized office network--with offices in every state, our well-established relationships with small business lenders across the country, and our Agency's goal of helping entrepreneurs of all types have allowed us to serve small businesses well, including veteran-owned small businesses.

As of March 31, 1993, the SBA's loan portfolio included approximately 18,500 business loans made to veterans through our guaranteed and direct loan programs. This is approximately 15 percent of the total number of SBA loans and represents roughly $2.6 billion, or 14 percent of the total dollars outstanding.

In fiscal years 1991 and 1992, and in the first six months of this fiscal year, the Agency increased its business loans to veterans. Attached to this testimony are loan approval figures for this period.

Although Public Law 97-72 authorized the Veterans Administration, now known as the Department of Veterans Affairs, to make and guarantee small business loans, we are advised that funds were never appropriated for this purpose and no loans were ever made.

However, the Small Business Administration has made more than 2,300 loans for approximately $165 million under the same provisions, PL 97-72 and PL 97-377, since they were enacted. Congress has consistently funded this program in SBA's appropriation every year since 1983.

The proposed "Veterans' Small Business Loan Act" has a number of parallels to the SBA's business loan program. It envisions loans made through private sector lending institutions, including SBA's certified and preferred lenders, under a guaranty loan program administered by the Department of Veteran Affairs. In reviewing the proposed legislation, we find that it appears to duplicate SBA's business loan program in several key areas.

As with other lending institutions, our Agency has certain credit and policy requirements that all applicants, including veterans, must meet. Among these are adequate equity investment in the business, evidence of the ability to repay the loan from earnings, and a reasonable amount of collateral to protect the interest of the taxpayer.

The proposed legislation differs from the SBA program by setting a maximum guaranty of 50 percent versus SBA's 90 percent. It establishes a maximum maturity of 10 years compared to SBA's maturity of up to 25 years. And it extends the guaranty to loans made by any state, whereas SBA's guaranty is limited to financial institutions.

Under the pending legislation, the veteran would pay a 2 percent funding fee, plus a 2 percent guaranty fee if the lender chose not to pay it. This would usually amount to a 4 percent fee for the veteran since lenders, in most cases, pass guaranty fees on to borrowers, as permitted in both SBA's legislation and in the pending legislation.

The proposed legislation also authorizes a secondary market for the DVA-guaranteed loans, not unlike the SBA's very active secondary market. SBA-guaranteed loans sold in the secondary market are backed by the United States, but the proposed legislation does not specifically provide for the same full faith and credit support.

As we understand it, the pending legislation provides that the Secretary of Veteran Affairs would pay on a default prior to a sale of collateral. This payment would be calculated by taking the outstanding balance and subtracting an estimate of the value of the collateral and the assets of the business, including goodwill. Under SBA's program, SBA and the lender share in the sale of the collateral recoveries and the ultimate losses, in the same proportion as the guaranty.

In another departure from SBA's program, the Secretary of Veteran Affairs would be prevented from obtaining personal guarantees from borrowers, and the borrowers would have no personal liability for losses sustained by a failed business, except where fraud, misrepresentation or bad faith is involved. It is important to note that both the SBA and private sector lenders have found through years of experience that personal guarantees are a critical part of extending credit.

When the proposed legislation's key points are compared to the existing SBA business loan program, it appears that duplication would exist. In light of the facts and the issues that have been raised about the bill, we would suggest that the Committee defer action until these issues can be considered more thoroughly.

Thank you for allowing me to appear before you, and I would be pleased to address any questions.

VETERAN LOAN APPROVALS

FISCAL YEARS 1991,1992,1993

AS OF MARCH 31, 1993

F/Y	MAJOR PROGRAM	# LOANS	TOTAL $	SBA SHARE
91	EOL	31	1,601,100	1,601,100
91	GENB	2,685	580,047,165	467,090,664
91	HAL	15	1,508,728	1,484,228
91	LDC	1	600,000	408,000
91	VET	211	14,846,858	14,846,858
91	504	104	27,729,000	27,729,000
91	8A	2	150,000	150,000
TOTALS		3,049	626,482,851	513,309,850
92	EOL	24	1,884,400	1,884,400
92	GENB	3,327	772,539,638	627,220,019
92	HAL	13	986,626	986,626
92	LDC	2	540,912	459,775
92	VET	225	16,069,488	16,069,488
92	504	115	33,247,000	33,247,000
92	8A	3	1,100,000	1,100,000
TOTALS		3,708	826,368,064	680,967,308
93	EOL	1	42,000	42,000
93	GENB	1,800	450,136,852	366,015,024
93	HAL	5	445,000	445,000
93	LDC	2	1,500,000	1,251,000
93	VET	104	8,036,641	8,036,641
93	504	56	16,291,000	16,291,000
93	8A	3	350,732	350,732
TOTALS		1,971	476,802,225	392,431,397
GRAND TOTALS		8,729	1,929,653,140	1,586,708,555

NOTES:

EOL - Equal Opportunity Loan Program - Loans for businesses located in any area having a high percentage of unemployment; located in any area having a high percentage of low-income individuals or owned by low-income individuals.

GenB - General Business Loans - Loans made under our 7(a) guaranty authority.

HAL - Handicapped Assistance Loans - Loans made to businesses owned by a handicapped person or Loans made to public or private nonprofit sheltered workshops.

LDC - Local Development Company - loans made through a development company organization for the benefit of a small business.

Vet - Veteran Loan Program - Direct loans made to Vietnam-era and disabled veterans loans.

504 - Loans made through a Certified Development Company to small businesses for long-term fixed asset financing.

8(a) - Direct and guaranty loans made under section 7(a) (20) to provide a source of financing for small business firms participating in the 8(a) program.

PARALYZED VETERANS
OF AMERICA
Chartered by the Congress
of the United States

STATEMENT OF

CLIFTON E. DUPREE, ASSOCIATE LEGISLATIVE DIRECTOR

PARALYZED VETERANS OF AMERICA

BEFORE THE

SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS

OF THE HOUSE COMMITTEE ON VETERANS' AFFAIRS

CONCERNING

"VETERANS' SMALL BUSINESS LOAN ACT OF 1993"

MAY 13, 1993

Mr. Chairman and Members of the Subcommittee, Paralyzed Veterans of America (PVA) thank you for inviting us to testify today. This legislation, introduced by you, Mr. Chairman, will bring meaningful support to the government's on-going responsibility to assure the economic well-being of those who have served in the defense of this nation.

Mr. Chairman, PVA has contended for many years that the VA could do more to promote small business opportunities for veterans.

Basic special consideration provisions and currently designed veterans' programs have gone part of the way to assure an emphasis for veterans in the distribution of small business opportunities and services among targeted populations.

There are about 3.5 million veteran owned businesses in the United States. Veterans, particularly Vietnam Era veterans, have a low rate of business ownership compared to other groups. Businesses owned by veterans tend to be newer, smaller and less secure, financially, than nonveteran-owned concerns.

For disabled veterans, in particular, starting a business presents additional challenges in obtaining capital and maintaining adequate income levels. Disabled veterans experience a higher rate of business failures than their nondisabled veteran peers. Disability can bring unique physical as well as personal and economic challenges.

In October 1992 the Disability Income Systems, Inc., in cooperation with the Paralysis Society of America, released the "Economic Consequences of Traumatic Spinal Cord Injury, Analysis of Post-Injury Employment Patterns."

The report stated:

> "Spinal Cord Injury (SCI) persons injured at working age (18-64) represent about 147,000 individuals.
>
> This group best represents those individuals who would face employment decisions after their injuries. This survey's analysis of post-injury employment shows that the average months that individuals with SCI were not employed immediately after injury exceeded sixty months.
>
> Younger persons (18-35 years old) tend to take longer to become employed after their injury. Those who were 26 to 35 years old at time of injury tend to return to the work force earlier. Persons with long initial hospitalization tend not to work in blue collar occupations after their injury. After injury quadriplegics tend to remain employed longer in their first job.
>
> Individuals with service-connected injuries have post-injury work rates higher than those with nonservice-connected injuries. However, they tend to take much longer to return to work.
>
> SCI veterans tend to be unemployed longer after their injury than the general SCI population.
>
> According to this survey disabled veterans remained unemployed an average of ninety months immediately after injury, with only forty-six percent returning to the work force after injury. No other demographic group under age 65 of any size has such a small proportion working.

The physical challenge of a disability is not the only reason an individual cannot find work or gain the experience or financial credit to find a job or start a business. The Congress and the American people are trying to change both physical barriers in the environment and attitudinal barriers in society that have challenged people with disabilities.

While PVA strongly supports this legislative proposal, we would recommend that the bill be refined further by including certain provisions that would give the VA the ability to give special attention and consideration to the needs of disabled veterans seeking to start a business or enhance a current business operation.

This could be done by allowing disabled veterans to compete for contracts and capital such as the 8(a) and 8(c) minority enterprise programs managed by the Small Business Administration (SBA).

Disabled veterans should be able to compete for these programs as "socially and economically disadvantaged" individuals.

Veterans programs, benefits and services have always singled out disabled veterans as a priority group needing unique assistance whether it be for health care, employment, job training, or job placement programs. PVA has a strong interest in legislation that will assist veterans and especially disabled veterans to own their own business.

The two main attractions to this legislation are first, it is designed to give the VA primary operational responsibility, and second, it is estimated to provide an average of $3.6 billion in new business loans to be guaranteed annually with $1.5 billion the first year of implementation. A summary of the legislation follows:

The main purpose of this legislation would be to create a program within the VA designed to assist eligible veteran-owned small businesses through guaranteed small business loans.

It would also set certain criteria for veterans to qualify for a guaranteed small business loan, to include resource and oversight opportunities to insure that assistance to veterans is a clear objective in the Federal Government's small business economic development assistance program.

The Secretary of Veterans Affairs (hence forth identified as the Secretary) may provide loan guarantee assistance to a veteran's small business, not to exceed $100,000. The guaranteed loan can be used to: (a) finance plant construction, conversion, or expansion (including the acquisition of land), (b) finance the acquisition of equipment, facilities, machinery, supplies, or materials, or (c) supply the veteran's business with working capital.

The original liability of any loan guaranteed may not exceed fifty percent of the amount of the loan, and the liability shall decrease and increase pro rate with any decrease or increase of the amount of the unpaid portion of the loan. The liability may not exceed the original amount of the guaranty.

Each loan guaranteed shall be of sound value taking into consideration the credit worthiness of the veteran's small business concern (and the individual owners) applying for such loan, or so secured as to assure payment.

The Secretary may not guarantee a loan to a veteran's small business concern based on an ownership interest of a veteran if that veteran also has or had an ownership interest that was considered in qualifying for another small business for a guaranteed loan.

The veteran borrower shall have no liability to the Secretary for any loss resulting from default of such veteran except in the case of fraud, misrepresentation, or bad faith by such veteran in obtaining the loan or in connection with loan default.

By requiring fees of two percent for funding and loan guaranty protection, (which can be included in the loan and paid from the loan proceeds), veterans are protected from default similar to the VA Guaranteed Home Loan Program. However, veterans who are receiving service-connected compensation (or who but for the receipt of retirement pay would be entitled to receive compensation) should be exempt from these users fees.

It is important for the VA to work as a clearinghouse to connect small businesses with economic opportunities. Even more important in the promotion of small businesses is to make certain that the individuals have the skills to operate effectively and grow economically.

Mr. Chairman, we urge that, if this program is authorized, that Congress provide the resources to adequately staff and manage this important function within the VA. This concludes my testimony. I will be happy to answer an questions you might have.

STATEMENT OF

JAMES N. MAGILL, DIRECTOR
NATIONAL LEGISLATIVE SERVICE
VETERANS OF FOREIGN WARS OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS
COMMITTEE ON VETERANS' AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

WITH RESPECT TO

VETERANS' SMALL BUSINESS LOAN PROGRAM

WASHINGTON, D.C. MAY 13, 1993

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

On behalf of the 2.2 million members of the Veterans of Foreign Wars of the United States, I wish to thank you for inviting us to participate in today's most important hearing. One of the most important benefits a grateful nation may bestow upon her veterans is the opportunity to return to civilian life as productive citizens. The VFW commends this subcommittee and the full committee for its efforts in furthering that goal.

Last October, the Department of Veterans Affairs announced a new Small Business Loan initiative patterned after VA's highly successful Home Loan Program. Through its Home Loan Program, VA has assisted more than 12 million veterans in accomplishing the American dream of home ownership. It just stands to reason that a business program can be developed to meet other needs of the veteran community.

Before us today is a draft proposal entitled "Veterans' Small Business Loan Act of 1993." This draft bill provides for a five-year program which would guarantee up to 50 percent of a Small Business Loan--with a maximum loan amount of $100,000. This loan could be applied to the acquisition of land, equipment, and/or other business expenses. As is the case with the VA Home Loan Program, this proposed initiative will make it easier for veterans to obtain Small Business Loans with less red tape, lower interest rates, and less collateral.

According to VA, approximately 12.8 million veterans who served during and following the Vietnam Era may be eligible to partake in the Veterans' Small Business Loan Program. VA further estimates that approximately 200,000 loans could be guaranteed during the 5-year life of the program, beginning in 1993. Administered by the Department of Veterans Affairs, the program will be opened to Vietnam-Era veterans and all veterans who served following that era. The VFW commends this initiative in that it has the potential to create more than one million jobs and to help ease the impact of downsizing the military. The VFW supports the thrust of the draft proposal and appreciates the opportunity to offer comments on this initiative.

We do support the proposed changes in eligibility in the discussion draft contained in Section 3741. The new definition of "eligible veteran" would open up participation in business loan guaranties to Vietnam Era as well as post-Vietnam-Era veterans, including those veterans who may be prematurely ending a military career due to downsizing.

The VFW, however, disagrees with the draft's proposed changes contained in Section 3742 that, if enacted, would eliminate the Small Business Administration's ability to administer a loan program for veterans to include loan guaranties or direct loans. Since

the inception of the Small Business Loan Program in 1981 (P.L. 97-72), SBA has provided over 2,300 direct loans valued at $165.4 million to veterans. While it is questionable whether SBA did all that it could to qualify as many veterans as allowable for participation in the loan program during its early years, we are pleased with the progress made in this program over the last two years. During this period, over 87 percent of funds made available for loans were obligated. We, therefore, would welcome language stating that nothing in Section 3742 shall preclude the Small Business Administration from continuing to operate a program of direct loans to veterans.

We would also welcome a provision that would allow up to three eligible veterans to pool their entitlement. This would enable each veteran to obtain their individual "cap" amount while at the same time allow for a higher working capital amount to be accumulated where higher capital requirements are needed.

This concludes my statement. Again, the VFW appreciates the opportunity to present its views on the proposed Small Business Loan Program. I will be happy to answer any questions you may have.

Vietnam Veterans of America, Inc.
1224 M Street, NW
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STATEMENT OF

VIETNAM VETERANS OF AMERICA

Presented by

William F. Crandell

Legislative Assistant

Accompanied by

Paul S. Egan

Executive Director

Before the

House Veterans Affairs Subcommittee on

Housing and Memorial Affairs

on

Veterans Small Business Loans

May 13, 1993

DISCUSSION

Mr. Chairman and members of the subcommittee, Vietnam Veterans of America (VVA), appreciates the opportunity to present its views to the discussion of a draft bill to create a new small business loan initiative for veterans.

There is a real need for a solid program that will loan money to veterans for the creation and support of small businesses. Few such proposals have been seriously considered. The press release and small business proposal of last fall that stimulated the current hearing seems more like an election year gimmick than a serious proposal containing significant details. What VVA wants to make clear at the outset is that we would support a program that means business, and we have no interest at all in one that merely looks good. The program design and implementation are critical.

Another point we should make at the outset is that we do not base our support for small business loans for veterans on the thanks of a grateful nation. Any monetary display of thanks, in a time of scarce resources and a tentative economic recovery, should and must go first to veterans with service-related disabilities. Investment dollars, on the other hand -- which is what small business loans are -- cannot be doled out as rewards for courageous service. Instead, they must go to good investments, and we believe veterans in small business are just that.

Usually, people who go to the Small Business Administration (SBA) for loans have already been turned down elsewhere. They do not fit the standard indicators of being the best risks for the money. The SBA, rather than lend taxpayer dollars, guarantees bank loans for those applicants who seem least shaky, promising to back up 70% of the money loaned to them should they default. This is true of every category of SBA loan applicant, veterans and non-veterans alike.

The only references to veterans in the 452-page 1992 annual report of the SBA are those mentioning the failure of the Department of Veterans Affairs (VA) to meet its contracting goals to small businesses in general, to minority small businesses and to small disadvantaged businesses. These are references not to veterans, but to the VA. SBA had information, as it should, on women-owned businesses, Black-owned businesses, Hispanic-owned businesses, and Asian and American Indian-owned businesses, but it had no information on veteran-owned businesses, though veterans cross every one of these categories. The 1992 report has more information on businesses owned by Koreans and Vietnamese than on those owned by the men and women who served in these nations.

Yet these men and women constitute a vital resource that this country has -- for the most part -- tapped only in wartime. Too often government sees veterans only as the pathetic wreckage of war -- as the maimed, the crazed and the needy. A more realistic assessment would view veterans as those who, out of a dedication to things bigger than themselves, went to the back of the line and let others get started first.

Even so, most veterans have adjusted well to civilian life, and many have prospered. And why shouldn't they? The military teaches far more than a set of specific combat or technical skills. Veterans are men and women who understand teamwork, discipline, setting objectives and meeting them. They are seasoned at operating under pressure, at finding ways to do what needs doing even when they don't get much support. A veteran has a masters degree in organization, and a double degree in hard work. If you want to find a self-starter, find a veteran. We make great entrepreneurs and great employees.

Let us look at some specific concerns VVA has in creating a sensible small business loan initiative for veterans.

A COORDINATED VETERANS PROGRAM AT SBA

If throwing dollars at a problem is not how to solve it, loaning money aimlessly is even worse. Any investment of the size you envision should be secured by a smaller but genuine investment in staff and program. VVA envisages four prongs to such a program:

1. SBA needs to designate an Associate Administrator for Veterans Business Enterprise to coordinate the efforts of its Office of Veterans Affairs. This does not mean the creation of another bureaucratic juggernaut, but rather of a position of adequate rank to coordinate existing and new programs.

2. Personnel in local SBA offices for veterans assistance must be upgraded and required to promote outreach to veteran entrepreneurs, regional seminars on government procurement practices and SBA guidance to small businesses owned by veterans.

3. Congress must legislate a definition to the current vague requirement that SBA provide "special consideration" for veterans. Absent that definition, there is not and will not be special consideration.

4. SBA must redevelop Veteran Business Resource Councils around the nation to offer guidance and counseling to veteran entrepreneurs. The networking such councils can provide will stretch the effectiveness of SBA guidance without expanding its budget.

OUTREACH TO VETERAN BUSINESS OWNERS

As the guarantor of last resort, SBA frequently lends money to owners who are poor investments, be they veterans or anybody else. As a practice, that makes SBA inept as an investor and inefficient as a welfare system. By targeting veteran employers through an outreach program that will bring in a broader range of veteran applicants, SBA can accomplish two parallel goals:

1. Drawing applicants who are better than marginal risks will maximize the stimulus to the economy that must be a primary purpose of SBA.

2. Improving the applicant pool through outreach to veterans cuts across all other categories of the population to aid a diverse mix of Americans.

PUTTING THE "SMALL" BACK IN SMALL BUSINESS LOANS

One of the problems with the Small Business Administration is that it supports middle-sized businesses. If we really believe that creating small businesses is a key to creating new jobs, we need to focus on loans of well under the $100,000 maximum loan amount mentioned in the bill. Such loans are, in many cases, too big to justify, encouraging the recipients to go in over their heads.

The legal minimum for an SBA loan is $25,000. That is too high. Loans in the $10,000-30,000 range would serve more new businesses, and serve them more realistically. SBA's new micro-loan program recognizes this, offering direct loans from SBA to not-for-profit developmental agencies which broker loans of under $25,000, targeting a range of $7,500 to $10,000. VVA would like to see some of these packages set aside for veterans, perhaps through veterans service organizations.

That is not to suggest that the scope of the program itself be diminished. The proposed average of $3.6 billion in new business

loans annually is a good investment in America's economy. Our suggestion is that smaller individual loans would be safer and would make the money go farther, giving the country, in essence, a more diversified portfolio.

Smaller loans also more accurately reflect the entrepreneurial needs of small business. In the real world, most small businesses start with five or fewer employees. Often, the entrepreneur himself or herself is the whole operation. The point at which help is most needed in starting a small business is at the beginning, when it needs a small loan that it will be able to pay back. Then after the business is up and running, if it is on solid ground, it creates more new jobs and takes off. Once this phase begins, the enterprise is on its own.

LINKING VETERAN ENTREPRENEURS AND UNEMPLOYED VETERANS

Our experience with veterans is that they like to help other veterans. Nowhere have we seen this any truer than in employment. The best reason for government to support the creation and survival of small businesses is that they provide jobs.

The greatest failing of the nation's labor exchange provided by the state employment services agencies is that they reach so few employers. To a great extent, capable workers stay away from the Job Service because they can't find good jobs there, and employers stay away because the best workers do. It is a vicious circle.

One way out of the circle would be to put into a veterans small business loan initiative a mechanism -- a funded and staffed office within SBA -- for linking the Department of Labor's Veterans Employment and Training Services with veteran entrepreneurs. The designation by SBA of an Associate Administrator for Veterans Business Enterprise to coordinate the efforts of veterans affairs officers would give direction to what is now a hopeless charade.

ENCOURAGE VETERAN ENTREPRENEURS TO USE SBA's SUPPORTS

Our experience with veteran entrepreneurs is that most of them have great raw talent, and many have practical hands-on experience to back it up. Fewer of them -- as is true of all other categories of SBA loan applicants -- have had opportunities for systematic training in technical matters or in management.

One of the things SBA does quite well is to provide technical and management assistance, in the form of both publications and advisors. While it would be going overboard to require that recipients of veterans small business loans utilize these supports, an aggressive effort to make them aware of what is available should be written into the legislation as a responsibility of an Associate Administrator for Veterans Business Enterprise.

SUPPORT VETERANS WITH SMALL BUSINESS LOANS

There will be clear parallels between a program of veterans small business loans and the VA's home loan program. One of them must be avoided from the outset by writing safeguards into the legislation that creates the veterans small business loan program. VA encourages foreclosure by lenders as an option of first resort when veterans default on their home loan guaranteed mortgages, regardless of whether these veterans might likely regain their economic footing. That short-sighted policy must <u>not</u> be extended to small business loans.

Sadly, VA has been permitted the freedom to adopt this foreclosure first posture because its authority to refinance the mortgages of defaulting veterans is entirely discretionary. Other federal agencies operating housing programs might also have adopted VA's posture but for statutes applying to those other housing programs which mandate administrative rights to refinancing for

individuals in default through no fault of their own. The Federal Housing Administration (FHA) of HUD and Farmers Home Administration (FmHA) of the Department of Agriculture realize what the GAO has proven: a policy encouraging foreclosure costs the government much more than refinancing.

VVA proposes specific legislative language designed to bring the veterans small business loan program into conformity with refinancing statutes applying to FHA and FmHA. In a time of slow recovery, it will be in America's best interest not only to make small business loans to veteran entrepreneurs, but to help those with the best chance of survival to stay viable.

CONCLUSION

Vietnam Veterans of America believes in veterans. If we didn't, we'd all be in some other line of work. The idea of a veterans small business loan program -- for it must be a program and not simply a bunch of loans given out at random -- excites us, because it offers us a chance to serve once again.

Create a simple coordinated effort to find a corps of veteran entrepreneurs, loan them reasonable amounts of money, help them stay on track by making seasoned coaching available, put them in touch with veterans who need work, and stick with them through hard times. Veterans are our least-utilized national resource, one we cannot afford to let rust. Use us!

Mr. Chairman, this concludes our testimony.

STATEMENT OF DON DWYER
VETERANS TRANSITION FRANCHISE INITIATIVE, WACO, TEXAS

HOUSE COMMITTEE ON VETERANS AFFAIRS

RE: Veteran's Small Business Loans

I am Don Dwyer an entrepreneur who has helped over 2,000 new entrepreneurs to realize the American Dream of owning their own business. I have authored two books on becoming an entrepreneur, my latest book is entitled "TARGET SUCCESS; How you can become a successful entrepreneur, regardless of your background." I am a director of the International Franchise Association, an organization that represents the majority of the companies that operate our country's 550,000 franchise outlets. And I am a veteran of the Korean Conflict.

I became deeply involved in the concept of helping veterans own their own business after the Gulf War. As you recall, our nation joined ranks and had an outpouring of support for those brave men and women who went to the Persian Gulf. At that moment in time, our association was looking for ways to make its contribution to this spirited effort to show we cared. That is when I founded the Veterans Transition Franchise Initiative or VET-FRAN, which was officially launched on Veterans Day 1991 at the Washington Press Club. The program is actively supported by the IFA, its Board, and its President, Bill Cherkasky.

The program has the participation of 115 of America's leading franchise companies; and they have agreed to give veterans up to a 50% discount of the initial licensing fee or finance up to 50% of this fee.

At the onset of the VET-FRAN program, it became obvious from letters from VET-FRAN's sponsors, and from veterans seeking a small business opportunity, that additional financing for veterans to start any business was extremely difficult to obtain–particularly in amounts less than $100,000. Banks and other financial institutions are reluctant to make small business loans of less than $100,000 because of the expense involved in administering them; It is more cost effective to have a few large loans than many smaller ones.

Additionally, veterans become bogged down in red tape when pursuing conventional financing and often get discouraged or miss a window of opportunity to purchase an existing business or start a new business.

And the strict standards of collateral observed by today's financing institutions, while somewhat necessary, do need some relaxing for veterans who have spent years in military service and consequently often accrue little collateral. Veterans find themselves spending $1500 to $3500 to have a professional put together their loan package with no assurance that they will get the loan.

Another problem is the instability of residence when one is in the military. It is just the nature of having been in military service to have re-located often during one's career. Financing companies do consider residence stability when evaluating a loan application, and it is often given considerable weight.

Lower interest rates through a VA administered loan would cause loan repayment to be easier and would assist in the profitability of a veteran's business. This profitability causes growth and expansion, and consequently creates more jobs. In fact, a new franchise opens every 16 minutes in the USA and creates, on average, 8 new jobs for Americans. If we help veterans open these franchises, they will be creating jobs for America. As I understand, the VA would

have a simplified loan application package thereby encouraging, rather than discouraging, these veteran applicants.

Still in its infancy, our VET-FRAN program for veterans and transitioning active military personnel has shown success, receiving over 10,000 inquiries, with some 300 small businesses being started through the program, and the creation of some 3300 new jobs across America. However, with a VA administered small business loan program in place, these numbers could easily have been increased ten-fold!

America's veterans have historically given of themselves to the defense and support of the American way of life and the concept of freedom of choice and opportunity for all who are, or would aspire to be, Americans. It is time for America to now stand and deliver the same energies toward her selfless men and women in the military.

The Department of Defense is not the only entity down-sizing its operations; corporate America is doing the same. Competition for jobs is fierce, and our veterans should be given another viable option to "job search," namely the opportunity to start a small business of their own.

We in the business community, the International Franchise Association, and the Veterans Transition Franchise Initiative heartily urge, and strongly support, the creation of a VA administered small business loan program to give veterans an opportunity to share in the "American Dream." This program is urgently needed now, and becomes even more essential as Operation Transition continues.

We strongly urge the VA to make special provisions for veterans who seek a franchise opportunity. The facts show that a franchise format business increases the likelihood that the veteran will have a greater opportunity for success. I believe that the Department of Commerce's statistics state that 95% of the people who start up a franchise opportunity are successful and that is due to the franchisor's comprehensive training, research and development and the quality management provided by the franchisor.

This is America's golden opportunity to decrease the likelihood of thousands of veterans "dropping out" of society as happened at the end of the Vietnam War when returning veterans found long unemployment lines and virtually no support for those wanting to start a business of their own.

A small business loan program for veterans is not a government expenditure; quite the contrary, it is an investment in America's future!

Thank you.

Supporting Documents Attached

INTERNATIONAL FRANCHISE SUPPORT CENTER
FRANCHISES AVAILABLE

March 27, 1992

Mr. Scott Denniston, Director OSDBU
Department of Veterans Affairs
810 Vermont Avenue, NW
Washington, DC 20420

Dear Mr. Denniston:

In speaking and corresponding with veterans throughout the United States the biggest road block we have encountered focuses on their inabilit y to penetrate the bureaucracy of the SBA. We have been receiving reports stemming from getting to the right people to restrictions imposed on collateral. We have been told of situations where SBA offices were not sure of the procedures for veterans to inadequate assistance in helping with the excessive paper work, along the countless other obstacles thrown in the path of our veterans.

Many veterans have turned to local banks only to be told the bank was not making small start-up business loans. In some cases bankers told the veterans you have no experience in the business and therefore you don't qualify for a loan. Obviously having no knowledge or understanding of the principals of franchising.

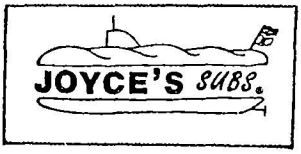
I'm sure the VETFRAN program was conceived with every sincere intent to assist our veterans, however with the numerous and diverse restrictions and obstacles thrown in their path it has fallen far short of its purpose.

Very truly yours,

John B. Gellatly,
Director of Development

JBG:mr

1330 South University Drive, Suite 400 Fort Worth, Texas 76107 Telephone 817-332-1575, FAX 817-332-5349, 800-544-1202



1527 HAVANA ST. • AURORA, COLORADO 80010 • 344-1674

March 27, 1992

Director
Dept. of Veterans Affairs
816 Vermont Ave NW
Washington, D.C. 20420

Dear Sir:

We have been a fast food franchisor since 1971, and have had occasion to try for SBA loans for approximately 16 franchises. Our experience with SBA was abysmal.

Since the Vet-Fran program began, we have had 3 veterans apply for SBA loans. It appears their M.O. has not changed. Long delays, no real interest in helping veterans, stumbling placed at each stage, has been our experience. After weeks of processing, the veteran is told no funds are available.

The V.A. support of the Vet-Fran program would greatly ease and assist these veterans in obtaining loans.

Sincerely,

David Meaux

DM/mls

D A R

DAR

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175-20 WEXFORD TERRACE (OFFICE B), JAMAICA ESTATES, NY 11432 • TEL: (718) 657-5876

January 12, 1993

Vet Fran
PO Box 3146
Waco, Texas 76707
Attention: Mr. Charlie Wood

Dear Mr. Wood:

Thank you for your recent inquiry regarding authorization to use my letter to your organization for Franchise opportunities. You may use my letter to further the cause of opportunity development for veterans and especially the needs of the retired and/or disabled veteran.

As I previously stated, the opportunities for employment seem to decrease substantially as age of the veteran increases. I am most disturbed at a prospective employer's apparent disregard of the veteran as a candidate to fill leadership and managerial functions which are often solicited in leading publications. Many veterans possess a wealth of experience in personnel management and asset utilization which is rarely equalled in the private sector. Most veterans have obtained a remarkable record of promotion achievement and job success in the military despite the tremendous competition they have faced when advancing among their peer groups. Employers are insensitive to the diverse educational needs and job experiences needed by a mid-level military manager to perform his/her military function and retire with distinction. Instead, the "White-Hair" factor becomes a deciding element by many resume reviewers when evaluating a veteran for an employment opportunity.

Sadly, as the drawdown of skilled military managers progresses into CY 1993, the impact of unemployed veterans upon our economy will worsen unless action is initiated to aid these individuals who have devoted the best years of their lives for our nation and suddenly find themselves unemployable. The veteran still has financial requirements for his family and self which are far beyond the limited pay allowed after completing at least 20 years of dedicated service. Often, the only potential solution seems to be an investment of lifetime savings by the veteran into a Franchise or other business.

On behalf of the Veteran, I applaud your efforts and stand ready to assist your actions to aid the veteran with better employment opportunities via Franchising and/or other business ventures. Few others in mainstream America possess the tenacity and intensity for success as the Veteran. Please work toward achieving a recognition of the problem and securing priority support by the government and industry to assist the Veteran in becoming a productive leader in our peacetime society. Help us get the programs, federal support and financing to make it happen!

Sincerely,

Rosario R. DiMaria
Lt.Col., USAF (Ret.)

Joseph F. Trzaska
10110 N. Loop Road
Pensacola, FL 32507
(904)492-5316

March 17, 1992

Mr. Baxter Coffie
President
VETFRAN Association

Dear Mr. Coffie,

I am writing this letter to bring to light the many problems I have encountered in my attempt to secure a business loan from the SBA.

First of all, I want it to be known that I want to work. Presently, both my wife and I are employed as professionals, but neither job offers us the least bit of job security or satisfaction. Being this as such, we both have a strong desire to better ourselves and our situation. This is where the idea of starting our own business came from. We both feel we have many talents that can be brought out and nurtured into outstanding qualities, from owning and operating our own business.

This was the start of over a year long search for the proper business for us to get involved in. During this time, we checked into many different types of businesses, ranging from network marketing to a variety of franchises. None of them felt completely right until I called about an ad on Worldwide Refinishing Company. This is where I first learned of the VETFRAN program, which offers a discount on the franchise fees for qualifying veterans, on the participating franchises. After some initial checking into the Worldwide Franchise and the Dwyer Group, I flew to Waco, TX on October 31, 1991 to meet with John Dobelbower, Vice President - Worldwide; and to see first-hand the training facilities and the operation of the franchise.

Upon returning from Waco, I thoroughly researched the offering circular from Worldwide and discovered I had some minor experience in this field already. After making many phone call inquiries to present and past franchise owners, and personally visiting another franchise owners in Panama City, Florida, my wife and I decided to pursue the possibility of purchasing our own franchise. After obtaining a breakdown of expenses involved in the initial buying of the franchise, we realized that the only way to complete this deal would be to get assistance in funding. Our first step in this process was to put together an infallible business plan. After completing a full analysis of the possible market area and figuring very realistic cash flow and profit and loss statements, we were ready to visit the banks with this information.

The first bank I visited was Barnett Bank of West Florida in Pensacola where I met with Bob Maloy, Vice President. After our first discussion, he stated that his banks policy was to have dollar for dollar equity in a deal before they would approve a loan, but he was impressed with my knowledge and confidence about the franchise and agreed to underwrite the request for an SBA-VETFRAN loan.

This started the almost impossible task of filling out an SBA loan package. My wife is a school teacher and I am an electronics engineer, and I believe we possess above average intelligence, but very little in the package made much sense to us. After finally completing the package in early February 1992, it was mailed to the SBA office in Jacksonville, Florida for their review. On February 13, I was notified by Mr. Maloy that there were a few problems with the package and it was going to be returned. On that same day, I contacted Mrs. Lucille Trotter, Senior Officer, SBA in Jacksonville to see if there was any way to keep the package from having to be mailed back and forth. During the conversation with Mrs. Trotter, I was formally chastised for wanting things to move too quickly. I was told that the SBA had a certain number of days to review a package and they could use every one of them. I also inquired into what the problems with the package were, and if there were any steps that could be taken to alleviate these problems without having to send the whole package back. She flatly told me 'NO' there was no way to do this!

The package was finally received back at Barnett Bank on February 24, where it was discovered that the problems with the package were known and documented on February 13 and yet was not mailed out until February 20. The so-called problems with the package seemed very minor and to my knowledge could have been taken care of the very same day they were discovered by the use of a Fax machine. The package with its corrections added, was mailed overnight mail on February 25, where no answer about it was received until March 13.

As per my phone conversation on the 13th with Mr. Maloy, I was told that as it stood, my loan request was being disapproved at the amount I had requested. I was told that the loan officer felt that there was no need for him to approve any of the remaining amount of the franchise fee, and that there was no reason at all that I should have $20,000 working capital; the most he would approve would be $2,500. I was also told that the quote I gave for the price of van at $17,482 was ridiculous and that it should not cost more than $13,000 to $14,000. I was also informed by Mr. Maloy that the SBA would be mailing the package back and if I resubmitted the package with new forms showing the cut back loan amounts, then they would again review it.

All I can honestly say to this is 'no thanks'. There is no

possible way to start and operate any kind of business with the ridiculous amount that the SBA has cut the loan down to. I feel this is very unfair! Just because I'm a small businessman, why should I have to spend all my personal money when so called "Big Business" does not do this.

In closing, I wish to thank Mr. Dobelbower for sticking with me through all this and also the Worldwide Franchise for holding my franchise rights to the Pensacola area through all this turmoil. It just proves that Worldwide has acted in good faith because of it's willingness to still work with me even after all these events have occurred.

If I'm willing to work and the franchise is willing to work with me through VETFRAN, then the only thing missing is the start-up capital. I'm not asking anyone for a handout. I'm only asking for the chance to succeed in owning and operating my own business.

Lastly, the SBA may be curious to know that I have lost over $9,000 in prospective revenues from possible clients and contracts. I have also lost 3 prospective employees due to the delay of processing this loan request.

Sincerely,

Joseph Trzaska

JOSEPH TRZASKA

Albert Andrews Ltd.
America's Custom Menswear Service

June 9, 1992

Mr. Scott Denniston
Director OSDBU
Department of Veterans Affairs
810 Vermont Avenue NW
Washington, DC 20420

Dear Mr. Denniston:

My company provides a custom tailored clothing service to busy executives at their offices, and we are offering franchises to qualified candidates who wish to open such a business in a viable market. We give our franchisees thorough initial training and intensive ongoing support in all aspects of running a successful enterprise.

As a participant in VETFRAN, my company offers a significant discount of the franchise fee to qualified veterans. We have been very pleased with the trend of inquiries by veterans or soon-to-be veterans, who were referred by VETFRAN. A number of these inquiries have lead to serious discussions, with these candidates expressing sincere enthusiasm about opening an Albert Andrews business. These people have been willing to place their own personal funds at risk to purchase a franchise, but have had to seek some outside capital.

Unfortunately, there are no practical sources of capital at this time. As a business owner, I am having enough trouble with my own banking relationships than to expect a recent veteran to secure a bank loan with no track record, because he/she has been in the military. Also, the logistics of securing a SBA loan are ridiculous.

Our unique company is growing nationally, bringing a needed service to the customer. We are creating opportunities for would-be entrepreneurs and their employees. We want to do our part to extend this opportunity to veterans, who have so loyally served our country, not to mention that these people bring with them a "discipline" which will serve them well as franchise owners.

I strongly urge the VA to quickly develop a practical financial assistance program, so that veterans have an immediate opportunity to contribute to the entrepreneurial spirit that has driven our national economy.

Sincerely,

Andrew L. Stern

Andrew L. Stern
President

VET-FRAN
P.O. Box 3146
1010 University Parks Dr.
Waco, Texas 76707
(817) 753-4555

May 5,1993

The Honorable George E. Sangmeister,
Chairman, Subcommittee on Housing and Memorial Affairs
U.S. House of Representatives
Committee on Veterans' Affairs
335 Cannon House Office Building
Washington, DC 20515

Dear Mr. Sangmeister:

It is with great honor that we, at VET-FRAN, accept your committee's invitation to testify at the hearing on the issue of a Veterans' Administation initiative for Small Business Loans.

Due to previous committments I will be unable to attend; however, I have requested that VET-FRAN Founder, Don Dwyer appear in my stead. Mr. Dwyer has indicated a willingness to appear, provided he can adjust his schedule accordingly. If he finds that he is unable to appear, he will request an officer of the International Franchise Association (IFA) to stand in for him. In any event, I assure you that VET-FRAN will be well represented.

We are deeply honored by your invitation and apologize for any inconvenience caused by our scheduling conflicts.

Sincerely,

C.H. Wood
VET-FRAN Administrator

Co-Sponsor

STATEMENT OF
RONALD W. DRACH
NATIONAL EMPLOYMENT DIRECTOR
DISABLED AMERICAN VETERANS
TO THE
SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS
OF THE
COMMITTEE ON VETERANS AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
MAY 13, 1993

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

On behalf of the more than 1.4 million members of the Disabled American Veterans (DAV) and its Women's Auxiliary, I am pleased to appear before you today to discuss draft legislation to establish a small business loan initiative for certain eligible veterans.

Mr. Chairman, at the outset let me state that the DAV is supportive of efforts to establish such an initiative for veterans but we suggest a different approach may be in order. Public Law 97-72 (Section 3751, Title 38 USC), in part authorized a onetime appropriation of $25 million for a Small Business Loan Program, providing loan guarantees and direct loans. Regrettably, this appropriation was never provided and the program expired September 30, 1986.

We understand that because of the high rate of business failures, banks are generally reluctant to provide loans for the start-up of small businesses. This would be true for veterans and nonveterans. The idea of the VA providing either direct loans or loan guarantees certainly goes a long way toward providing needed financial assistance for qualified veterans who want to start their own businesses.

Mr. Chairman, we recommend the authorization for appropriation of $25 million contained in Section 3751 be extended until at least September 30, 1996. We believe Title 38 USC Chapter 37 currently contains sufficient authority for the VA to carry out a very effective Small Business Loan Program both through direct loans and loan guarantees that would meet the intent of the draft legislation. We do, however, believe that several provisions in your draft legislation should be considered at this time.

We support your amendment to Section 3741 which changes the definition of disabled veteran to read "the term 'eligible veteran' means -- (A) a disabled veteran;." Current legislation restricts disabled veteran eligibility to those who are "entitled to compensation under laws administered by the Secretary for a disability rated at 30 percent or more, or (B) a veteran who is discharged or released from active duty for a disability incurred or aggravated in the line of duty." The DAV has long believed that employment programs for disabled veterans should include all disabled veterans and not only those whose disability is rated at 30 percent or higher.

Your draft legislation also extends eligibility to those who served during "the Persian Gulf war and whose total service was for 90 days or more." We recommend this definition be expanded to include others who have received a Department of Defense authorized service medal such as those for service in Beirut, Panama and elsewhere. In some instances reserve and National Guard units may have been deactivated prior to 9C days. We encourage you to amend the language "total service was for 90 days or more" and include "or meets the requirement of Section 5303A (b)(1)(B) of this title."

The draft legislation amends Section 3748, Title 38 USC by deleting "Preference For Disabled Veterans." We urge you to retain that section.

Mr. Chairman, when former Acting Secretary of Veterans Affairs, Anthony Principi announced the idea of providing business loan guarantees for veterans we told him we supported his concept. We also told him that we believed additional steps should be taken to help existing small businesses owned by veterans and disabled veterans by establishing a "set aside" program for veteran owned businesses.

Attached to our statement is a copy of Resolution No. 141 adopted by our most recently concluded National Convention. This resolution supports legislation that would "provide service-connected veterans special status for priority receipt of federal contracts that are 'set asides' as well as noncompetitive contracts, equal to any other economically disadvantaged group."

Mr. Chairman, on March 12, 1991, Congressman McDade along with Congressmen Montgomery and Penny introduced H.R. 1404 which largely satisfied the DAV's resolution. On May 15, 1991, the Subcommittee on Education, Employment and Training of the House Committee on Veterans Affairs held a hearing on H.R. 1404, but it was never enacted. Legislation comparable to H.R. 1404 would amend the Small Business Act and require sequential jurisdiction with the Committee on Small Business. We believe in order to provide needed assistance to veterans who either own their own business or are desirous of starting their own business, both approaches must be pursued.

In spite of legislation dating back as far as 1975, we believe veterans attempting to start their own business and those who already own their own business have not received the attention from the Small Business Administration (SBA) they need. The approaches discussed above provide a comprehensive approach to assuring these veterans receive the assistance and attention they so richly deserve.

Mr. Chairman, veterans are unique in many ways. Because of their unselfish dedication and the fact they are the only group in this country that is a product of the federal government, they deserve the assistance as discussed here. For many years other groups in this country have benefited from SBA programs through receipt of procurement contracts and certain benefits of management and technical assistance targeted to individuals belonging to a particular class. Veterans have not enjoyed similar status, but deserve no less.

Mr. Chairman, we very much appreciate your interest in reviewing the issue of small business incentives for veterans. We would be very pleased to work with you and members of your staff toward enacting meaningful legislation which would attain that goal. That concludes my statement and I will be happy to answer any questions.

STATEMENT OF JAMES B. HUBBARD, DIRECTOR
NATIONAL ECONOMICS COMMISSION
THE AMERICAN LEGION
TO THE SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS
COMMITTEE ON VETERANS AFFAIRS
U. S. HOUSE OF REPRESENTATIVES
MAY 13, 1993

Mr. Chairman and distinguished members of the Subcommittee: The American Legion is pleased to have an opportunity to express its views on the VA's small business loan initiative. Earlier this month, the Legion's National Executive Committee adopted Resolution No. 7 which mandates the organization to support this VA proposal.

Before commenting on the draft legislation currently before this Subcommittee, we would like to take just a moment to review the history of federal assistance to veteran-owned small business.

The first such program dates back to 1944. In that year, Congress passed the **Servicemen's Readjustment Act of 1944**. Among other things, that legislation established a small business loan program for World War II veterans that was to be administered by the VA. The program's first eight years were so successful that Congress later opened it to Korean War veterans.

In 1953 Congress passed legislation that created the Small Business Administration (SBA) and provided for the transfer of the veterans' small business loan program to the new agency. Despite the 1974 passage of PL 93-237, which mandated the SBA to provide "special consideration to veterans of the Armed Forces of the United States and their survivors and dependents," little, if anything, was done until 1980 to promote the SBA's veterans' programs.

Following enactment of PL 93-237, it was nearly two years before the regulations implementing "special consideration" were printed. Even then, nothing in the

regulations established veterans as a special or priority agency concern.

During oversight hearings that were held in the House and Senate in 1980, the SBA was presumably embarrassed into taking steps toward implementation of the law. As its first step, the SBA appointed Veterans' Affairs Officers in each of its district offices and gave them responsibility for providing "special consideration" to veteran-entrepreneurs. Its second step was to initiate an outreach campaign to ensure veterans were aware of their rights and to provide them with information and assistance.

Over the next few years a genuine partnership was formed between the SBA's Office of Veterans' Affairs (OVA) and the veterans' service organizations (VSOs) as they worked together to develop a meaningful veterans' program.

At the request of the VSOs and the House Veterans' Affairs Committee, a task force consisting of representatives of the SBA, VA, DoL and the VSOs was established in 1981 to define thoroughly the agency's responsibilities to veterans and to make recommendations for future action. The task force's report was submitted in early 1982. In May the Administrator issued a policy statement which detailed the agency's mission regarding veterans.

Over the next seven years the SBA demonstrated a commitment to veterans and to its responsibilities under the law. According to SBA statistics, veterans received only 12 percent of all loan dollars in 1980. During the following years, the percentage increased considerably. In 1983 the SBA reported that the percentage had doubled, and in the following year it was up to 27 percent.

Unfortunately, in 1989 when a new Administrator was appointed, the SBA's support for its OVA and its commitment to veterans evaporated. Because of that Administrator's interest in promoting other programs within the SBA, veterans were all but forgotten by the agency.

The next Administrator not only continued the policies of her predecessor, but also went so far as to refuse to reconstitute the SBA's Veterans' Advisory Committee. As a result, the representatives of this country's 27 million living veterans have not had a formal voice at the agency since last June. We must also point out, Mr. Chairman, that despite numerous requests, both of those administrators refused to meet with representatives of the veterans' community to discuss our concerns.

Mr. Chairman, The American Legion finds the SBA's attitude towards veteran-entrepreneurs over the past four years to be intolerable. We have taken the liberty of attaching to our written testimony, a copy of a letter that was recently sent to Dayton J. Watkins, the current Acting Administrator of the SBA. We think it very clearly states our concerns about the SBA's shabby treatment of its OVA and this country's veteran-entrepreneurs.

Having said that, we would now like to turn our attention to the VA's draft legislation that is currently being considered.

As the members of the Subcommittee know, Congress passed legislation during the early 1980s that amended Chapter 37 of Title 38, United States Code, by establishing a small business loan program that was to be administered by the VA. That pilot program was never funded and was subsequently allowed to sunset on September 30, 1986.

Recently the VA announced an initiative that calls on Congress to reauthorize its former small business loan program and to make numerous technical adjustments to the legislation that was adopted in the 80s. In view of the SBA's lack of concern for veterans over the past few years, The American Legion supports the VA's initiative.

Today, there are many thousands of Americans who have become unemployed through no fault of their own and who, because of the economy, have been unable to find new jobs. To make matters worse, many more thousands of Americans will become unemployed over the next few years because of the down-sizing of the military and the closure of military bases.

The VA has estimated that if its small business loan program is reauthorized it can help to create a minimum of one million new jobs over the next five years. If that estimate seems plausible, then The American Legion believes that this Subcommittee must give the VA's initiative its full attention.

Mr. Chairman, that concludes our testimony. We will be happy to answer any questions you or the members of the Subcommittee may have.

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Gumersindo Gomez
Executive Director

Sergio Kentish
President

April 26, 1993

United State House of Representative
Committee on Veterans' Affairs
333 Cannon House Office Building
Washington, D.C. 20515

RE: The need to provide opportunity for Small Business to Hispanic Veterans.

On behalf of the Board of Directors of the Puerto Rican Veterans Association of Mass., Inc. and the Puerto Rican Veterans of Massachusetts, we thank you for giving us the opportunity to make this presentation.

Because of the unemployment rate within the area that we serve our veterans, which is one of the highest in Western Massachusetts, it is important to provide Hispanic Veterans with the opportunity to start their own businesses'. With this establishment of businesses, these veterans will be able to hire other veterans in their particular businesses.

We affirm very strongly that the economy of this country will be helped with small business in the community and the hiring of community people to work in these businesses. Since 1987 the effects of the economy in America have been painful and profound. More than 6 million permanent pink slips have been handed out, and layoffs are occurring at an even faster pace this year than in 1992. Despite signs of a brisker economy, at least 87 large firms announced major job cuts in the first two months of 1993 alone.

But, for our Hispanic Veterans, the established Small Business Offices located throughout the region are not the answer. Why? The lack of bilingual/bicultural personnel in these offices does not provide the sensitiveness and reassurance that our veterans need to go through a process that is filled with red tape.

The way to proceed, so our Hispanic Veterans will have a chance in the system, is through established agencies in the region that work with our community and that can render the type of guidance they need to achieve success in their business plans.

One of these agencies is Brightwood Development Corporation in Springfield, Massachusetts. We, the Puerto Rican Veterans Association in conjunction with Brightwood Development Corporation, have been successful in establishing two small businesses with veterans in the last year. We are currently working to establish two others and the outlook is positive for them.

In conclusion, we ask that this Committee take into consideration ways in which financial aid from the Small Businesses Administration can find its way to the different community agencies that work with Hispanic Veterans and their families, in order that our veterans get a chance to enter the small business world.

Respectfully,

Gumersindo Gomez
Executive Director

GG/wm

Non Commissioned Officers Association of the United States of America

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STATEMENT OF

RICHARD W. JOHNSON
EXECUTIVE DIRECTOR OF GOVERNMENT AFFAIRS

SUBMITTED TO

SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS
COMMITTEE ON VETERANS AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

ON

VETERANS SMALL BUSINESS LOANS

MAY 13, 1993

Mr. Chairman, the Non Commissioned Officers Association of the USA (NCOA) sincerely appreciates this opportunity to provide its comments on the Veterans Small Business Loan Act of 1993. Just as noncommissioned and petty officers are the backbone of the armed forces, small businesses are the backbone of our nation's economy. Expanding veterans access to small business opportunities is a goal fully supported by the association.

SMALL BUSINESS AND VETERANS

Small businesses across the United States employ more people than any other enterprise or industry. The average small business employs 11 people. Collectively, small businesses represent more than half the tax revenues collected from businesses nationwide and contribute more significantly than any other public sector to community support activities. They are the little league sponsors, the bowling league sponsors, the volunteer fire department donors, etc. Literally, they make America the free enterprise capital of the world.

Veterans make excellent small business operators and owners. During their military service they learn many of the skills needed to be successful. Small unit leadership, personal discipline, and focus on objectives are skills learned in service that are transferred to small business operations. Too often, however, veterans lack the capital necessary to start a small business.

While the average small business owner earns about $126,000 per year, the average start-up cost ranges from $75,000 to $300,000. Franchise businesses can cost even more. Few veterans can raise the money need to start a small business without assistance.

SMALL BUSINESS ADMINISTRATION

The Small Business Administration has been very helpful in filling this void over the years. Unfortunately, the funding available to SBA and the priority assigned to veterans sometimes works against even the most dedicated entrepreneur. NCOA has nothing but the highest regard for the SBA in general and its Office of Veterans Affairs in particular. Nevertheless, the association believes a less rigid, less structured program would be beneficial to veterans.

THE SMALL BUSINESS LOAN INITIATIVE

The Small Business Loan Initiative proposed by the Department of Veterans Affairs is an outstanding idea. Conceptually, it has NCOA's full support. As the services continue to decrease in size from 2.2 million to 1.2 million uniformed personnel, the need to provide jobs, and job opportunities to these veterans is extraordinary. Initiatives that will allow some veterans to start small businesses will ultimately mean employment for other veterans as well.

Under the terms of the initiative veterans could borrow up to $100,000 with a 50 percent guaranty to the lender. The loan would be funded by a 2 percent funding fee that would indemnify the veteran against any loss and a 2 percent guaranty fee.

Mr. Chairman, NCOA is concerned that the financing method may not be adequate to the program goal. First, it should be noted that the average small business loan currently exceeds $200,000. It should also be noted that current government guarantees on small business loans ranges from 70 percent to 90 percent. Since this program will rely on commercial lenders for financing, it is reasonable the project that few will be interested because of the greater risk involved in the veterans initiative. Additionally, it will be difficult for veterans to obtain sufficient funding with the loan limits projected for the program.

Currently only about 3,500 veterans per year receive SBA assistance while the veterans initiative is expected to assist 40,000 veterans. NCOA believes it would be reasonable to double the loan amount even if it reduces the veterans population served by half. Such a move would improve financing opportunities and give businesses a greater chance of survival. NCOA also suggests that the committee explore alternative financing proposals. One that has

been regularly suggested to the association would allow an interest only payment period. Under this method, veterans would be allowed to pay only the interest on their loans for one to five years while the business gained stability.

CONCLUSION

Mr. Chairman, as previously stated, NCOA fully supports the concept of establishing a small business loan program for veterans. However, we believe it should be one that is flexible in its ability to meet the needs of veterans.

Thank you.

SERVING
WITH
PRIDE

AMVETS

STATEMENT FOR THE RECORD

on

SMALL BUSINESS LOANS FOR VETERANS

before the

SUBCOMMITTEE ON HOUSING MEMORIAL AFFAIRS

COMMITTEE ON VETERANS AFFAIRS

HOUSE OF REPRESENTATIVES

May 13, 1993

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AMVETS has for some time now believed the Department of Veterans Affairs must take a much stronger leadership role in the administration of all veterans' programs. We have seen on far too many occasions that when another federal agency is charged with administering veterans' programs, the programs quickly become diluted and often ineffective. An example of this may be found in the U.S. Small Business Administration's (SBA) testimony before this committee. While it does not show how many veterans applied for SBA loans, it does show that in fiscal year (FY) 1991, 211 veterans loans were processed; in FY 1992, 225 and as of March 31, 104. The current proposal administered by VA estimates that as many as 200,000 loans could be guaranteed during the five-year life of the program, thus there is no comparison once one realizes that SBA's veterans loans total 2,300 since the passage of Public Law 97-72 in 1981.

Therefore AMVETS supports transfer of veterans small business programs from the jurisdiction of SBA to VA. That includes all authorized personnel and funds currently allocated to such programs. We feel VA, given the resources now assigned to SBA for veterans programs will provide significantly more emphasis than the programs now receive and will be instrumental in creating a strong new group of veteran entrepreneurs.

We support the basics of the draft proposal and are extremely pleased that the VA will administer this program for veterans. We have only two concerns. The first is in the area of funding. Adequate appropriations must be provided which include monies for administration. The VA must not be required to absorb any new or additional programs without new or additional funding. The second is the decrease in the maximum loan amount from $200,000 to $100,000. This reduced amount may act to inhibit new business ventures because of today's high costs of equipment and personnel. It may also act to increase the failure rate of new businesses due to under capitalization - the most common reason for business failure during the initial years of operation.

We especially like the provision that will broaden the eligibility to all honorably separated veterans who have served since 1975 and removal of the disability rating restrictions. We also agree with the provision to allow a veteran to include the 2% funding fee in the loan amount.

AMVETS views this proposal as an investment in America and who better to invest

with than our veterans. Based on current unemployment rates and the downsizing of our military forces, the potential to create some one million jobs just makes good sense.

Perhaps an additional area that should be explored is the possibility of two or more veterans pooling their entitlement/eligibility if they wished to start a business together.

This proposed draft will stimulate even more interest in a currently successful program known as VET-FRAN. AMVETS, has been impressed with the individuals who worked so hard to implement the VET-FRAN program and now we are equally impressed with the program itself.

New business, new jobs, new tax revenues — a win-win outcome. This concludes our statement.

RESPONSE TO POST-HEARING QUESTIONS FROM THE MAY 13 HEARING OF THE SUBCOMMITTEE ON HOUSING AND MEMORIAL AFFAIRS.

QUESTIONS SUBMITTED BY CHAIRMAN SANGMEISTER AND REPRESENTATIVE DAN BURTON

QUESTION: Do you support the recommendation of Mr. Terrell of BancBoston that VA establish a liaison who educates veterans, processes applications, and creates standardized documentation for program eligibility? (Note: for this recommendation Mr. Terrell assumes VA will rely on SBA programs to provide small business loans to veterans.)

ANSWER: SBA has current capability and experience in processing business loan applications and therefore would be better able to educate veterans about the risks and rewards of business ownership. VA already determines veterans' entitlement for home loans and could perform a similar function with regard to small business loans. However, beyond the issue of basic eligibility, VA does not presently have any expertise in the business loan area to provide to veterans seeking assistance.

QUESTION: What would VA view as a reasonable percentage of a small business loan to require a veteran's personal guaranty on?

ANSWER: We are unaware of any loan programs which limit the borrower's personal liability to a certain percentage of the loan. In business lending situations, an individual borrower is personally liable for the entire debt. When the borrower is a corporation or other legally recognized business entity, a lender may limit liability for the debt to the entity alone or require personal guaranties from the individuals comprising the entity. With a new business or a business without strong historical performance, individual guaranties are a reasonable requirement by the lender.

QUESTION: What role can VA staff serve as an advocate/liaison for veterans within the SBA bureaucracy? How might SBA modify its current small business loan application process to streamline applications submitted by veterans?

ANSWER: VA staff liaison with SBA would probably be limited to the referral of veterans to the appropriate officials within SBA. VA does not have sufficient expertise concerning SBA's programs and procedures to provide recommendations on how to streamline SBA's loan application process.

QUESTION: How much would the proposed VA small business loan guaranty program cost to establish and operate?

ANSWER: Because the draft bill language for the proposed VA small business loan program does not clearly state whether a lender would be able to require that the loans be secured by collateral, the default rate assumption and hence the cost of the program is uncertain. (next page)

If the program was structured so that loans have a 50 percent government guaranty, but no other security (i.e., collateral), lenders would generally make such loans only to the most creditworthy, experienced borrowers. We cannot be certain how many veterans would actually be able to meet a lender's strict criteria under such a program. We suspect that most of those who would qualify for such loans would already be able to obtain financing either through an SBA program or from conventional sources. Under this scenario, the costs would most likely be minimal because strict underwriting standards would result in a low default rate.

However, if the program was structured so that the lender has a 50 percent guaranty and is allowed to require collateral equal to at least 50 percent of the loan amount, the risk to the lender would be minimal. Under this scernario, we expect a default rate at least equal to the 19 percent default rate on SBA loans which have on average guauanty of 81%. The estimated five-year cost with a 20% default rate is $432.1 million. For this estimate, it was assumed that the loan volume would be 200,000 over five years and that the average claim paid by VA is 40%. The Administrative costs to operate a program of this size are estimated at $18.8 million for a five-year period.

As explained above, the cost of the proposed VA small business loan guaranty program is uncertain because the program structure is unclear with respect to collateral.

Post Hearing Questions for the Small Business Administration

Subcommittee on Housing and Memorial Affairs

What is the reason most small businesses fail? Most small businesses fail due to poor decisions by inexperienced management.

How much funding do you currently have for the 7(a) program? SBA was authorized to guaranty approximately $3.6 billion in 7(a) loans for FY93. These funds have all been used. **Is this more or less than you had several years ago?** The $3.6 billion is less than the amount guaranteed in 1991 and 1992. It is more than any other year. **Since President Clinton has placed such a strong emphasis on small business loans for economic growth, have SBA's resources increased as well?** SBA has improved the efficiency of its operations as program levels have increased. Resources have not increased. **Do you project an increase in volume?** Yes, we anticipate that if funding is available, SBA could approve $8.0 billion of loans in FY94.

You state that the draft bill is somewhat duplicative of SBA's existing guaranty program. You have heard testimony this morning that Michigan's Capital Access Program complements SBA's 7(a) program in the State of Michigan. Would you be supportive of a VA program similar to the Capital Access Program? Given some very important changes, we would be supportive. **If so, should such a program be extended to non-veterans as recommended by Mr. Rohde and would SBA be willing to participate?** We believe that the program should be limited to veterans.

If VA's primary mission is to provide services to veterans and SBA's is to serve the interest of small business owner, what role, if any, can VA staff serve as an advocate/liaison for veterans within the SBA bureaucracy? VA staff could serve in a liaison capacity by helping to inform veterans of the availability of SBA programs. **How might SBA modify its current small business loan application process to streamline application submitted by veterans?** SBA's loan application process is already streamlined, requiring the basic information needed to reach a credit decision. We do not anticipate needing different application procedures for veterans.

What is the amount of the average SBA Small Business loan made to a veteran? We have requested this information from our mainframe computer and will supply this information when received. **How does the actual loan compare with the amount requested by the veteran? More or less?** SBA does not keep statistics on changes in the loan application amount. In general, changes by the SBA loan officer to the amount requested are infrequent.

Considering that only 11 percent of SBA loans are for under $100,000 and the average is $242,000, what percentage of SBA loans are made for over $600,000. We have a report available which shows loan approvals over $500,000. Approximately 28% of the current portfolio had an initial gross loan balance over $500,000.

Has SBA performed a statistical analysis and comparison on the default rates of loans provided to veterans and non-veterans? No, we have not compared default rates. **If not, would you supply such data to the Subcommittee?** We have requested the above information and will forward it to you when available.

Post Hearing Questions from the Honorable Dan Burton

1. **Please explain why, if veterans comprise 20% of the small business population, veterans receive less than 14% of SBA loans?**

We do not believe that the fact that an individual served in the armed forces decreases their chances of receiving credit. In fact, if one considers the extensive training received by many service members, an argument can be made that the veteran is in a better position to organize his or her financial information and business plan and therefore, make a better presentation to a bank loan officer. Furthermore, the system that SBA uses to determine whether an applicant is a veteran is voluntary. It may be that some veterans do not inform SBA of their previous status.

What steps are necessary to increase the number of veterans receiving small business loans under SBA's existing programs?

In the case of SBA's guaranteed loan programs, it is usually the lender that determines whether the loan request from a particular customer needs a government guarantee. SBA has an ongoing outreach program to make lenders aware of the programs. We believe that ongoing cooperation between the Department of Veterans Affairs and SBA in reaching out to veterans groups will also assist.

2. It is my understanding that the average SBA loan is $242,000 and that only 11% of SBA loans are under $100,000. Please explain why so few loans are for amounts less than $100,000.

The 11% figure refers to the loan dollars to businesses that borrowed less than $100,000. Approximately 40% of the number of loans outstanding are in the $100,000, or less category.

Does it have to do with the amount of money needed to successfully start up a small business?

Certainly, as the cost of operating a business has risen over the years, so has the need for a higher level of financing for these businesses.

Is it, as has been alluded to in testimony, that there is a reluctance on the part of lenders to make small business loans of less than $100,000 because of the expense of administering them?

In most cases, it is less expensive to monitor one loan for $100,000 than four loans for $25,000. Lenders in some higher cost areas of the country may feel that small loans are too costly to monitor.

Assuming the credit risks are equal, what advantages/disadvantages are there for lenders to make one loan for $300,000 over making four loans of $75,000?

If only one loan is made, only one application package must be analyzed and reviewed by bank staff. Only one repayment check must be cashed each month. Only one borrower can be late in a given month, requiring only one telephone call or visit for collection. If four loans are made, all of the above activities are multiplied by four, except for the interest income on the $300,000. If the bank is charging 8% interest, $300,000 will generate $24,000 in interest income regardless of whether the income is from one loan or four loans. If the income is from four loans, the bank's expenses will be higher and their profits lower.

Does SBA track loans by amount, type of business, and success rate, and when applicable, reasons for failure?

SBA does not regularly track the success rate of loans by amount or by type of business, but has the capacity to provide reports using these two data items on an ad hoc basis. We do not track the reasons for failure.

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