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SBA REAUTHORIZATION: CREDIT PROGRAMS (PART I) ROUNDTABLE

ROUNDTABLE

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 30, 2003

Printed for the Committee on Small Business and Entrepreneurship

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Forbes, Patty, Staff Director and Chief Counsel, Minority Staff ..... *
Freedman, Marc, Regulatory Counsel, Majority Staff ..... *
Wach, Greg, Banking Counsel, Majority Staff ..... *

PARTICIPANTS

Bartram, David, President, SBA Division, US Bank, San Diego, California ..... *
Ballentine, James, Director, Community Development, Office of Federal Operations, American Bankers Association, Washington, DC ..... *
Bew, Ron, Associate Deputy Administrator, Office of Capital Access, U.S. Small Business Administration, Washington, DC ..... *
Brown, Blake, Chief Financial Officer, Coastal Enterprises, Inc., Wiscasset, Maine ..... *
Byrnes, Steven, Senior Vice President, Fleet Boston Financial, Portland, Maine ..... *
Corbet, Alan, Executive Director, Go Connection, Kansas City, Missouri ..... *
Criscitello, Douglas, Vice President, JP Morgan Chase (Colson Services), Washington, DC ..... *
D'Agostino, Davi, Director, Financial Markets and Community Investments, U.S. General Accounting Office, Washington, DC ..... *
Feldmann, Greg, Partner, Gryphon Capital Advisiors, Roanoke, Virginia ..... *
Gast, Zach, Policy and Research Manager, Association for Enterprise Opportunity, Arlington, Virginia ..... *
Hearne, Michael, Director of Member Business Lending Program, Credit Union National Association, Washington, DC ..... *
Matthews, Mary, President, Northeast Entrepreneur Fund, Inc., Virginia, Minnesota ..... *
Merski, Paul, Chief Economist and Director or Federal Tax Policy, Independent Community Bankers of America, Washington, DC ..... *
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SBA REAUTHORIZATION: CREDIT PROGRAMS (PART I) ROUNDTABLE

WEDNESDAY, APRIL 30, 2003

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
Washington, D.C.

The Committee met, pursuant to notice, at 9:42 a.m., in Room SR–428A, Russell Senate Office Building, the Honorable Olympia Snowe, Chair of the Committee, presiding.

Present: Senators Snowe and Coleman.

OPENING STATEMENT OF OLYMPIA SNOWE, CHAIR, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MAINE

Chair SNOWE. We welcome all of you here today. We will begin quickly. I will only be able to stay until about quarter of 11:00, so I want to be able to hear most of what you have to say on some of these issues and obviously the staff will be here, both my staff and Mark Warren, Marc Freedman, Greg Wach, and Patty on behalf of Senator Kerry.

We are going to be sure that we include all of your comments here this morning, because as we prepare for the reauthorization of the SBA programs we want to ensure that we have considerable input as we develop our recommendations for how we should proceed on the SBA reauthorization—all the more so, given the fact that it is the 50th anniversary of the SBA. I think there could be no better way to celebrate these programs, and the value that they represent to this country in developing America's economy, than ensuring the vitality of these programs and improving the well being of small businesses throughout the country.

I know that you represent a broad section of organizations and institutions that enable small businesses to thrive in America. We want to do everything that we can to ensure that these programs are working well and efficiently. If we have to redirect our efforts from ineffective programs to more effective programs then we certainly want to do that. Anyway we can improve the delivery of these services to small businesses, and through your institutions, we want to do that as well.

The program that we are talking about today is the SBA's 7(a) Loan Guarantee Program, which is the essence, the core, of the SBA programs. I know you have been on the front lines in delivering these loans to small businesses. They put a face on America. Whether it is on Main Street or in manufacturing facilities, we are able to develop small businesses in a way that would not be pos-

sible without the assistance and support of these types of programs.

The 7(a) program has had a profound effect on America. During the last 3 years, the SBA 7(a) loan programs have provided financing to more than 40,000 startup small businesses and to more than 99,000 existing small businesses that received financing for operating and expansion purposes, totaling more than $28 billion in the same 3-year period.

More significantly, perhaps, is the fact that it has resulted in the creation of more than 1 million new jobs.

As we consider ways in which to improve the SBA guaranteed loan processes, we also should keep in mind that it is vital to provide support not only for startups but also for existing small businesses, so that we can protect the millions of jobs that have already been created.

Obviously the expansion of the 7(a) Loan Program has already made a difference, and I want to get your input today on the administration's proposal. We know that there are ways in which the 7(a) loan program can be improved and that is obviously what we want to hear from you today.

We have tried in the past, and I know the leadership here in the Committee and at the SBA, have tried, to improve upon the delivery of these services by reducing the burden of paperwork, obviously reducing the fees, and trying to deliver speedy services through the lending process.

We know the 7(a) program got a jump start with the Low Doc Program several years ago, and more recently the Express Loan Program that has proven that we can improve the 7(a) loan program. Hopefully that has worked well. It has done a lot, I think, in reducing the paperwork burden and the time it takes for a small business to obtain a 7(a) loan, and eliminating the SBA's internal loan processing, saving time for businesses and processing costs for the SBA.

I hope that your comments here today can help, I think, elaborate on these issues and whether or not they have worked well and identifying other facets of the program that we ought to be working on, where we have succeeded, and what we should emulate, and those areas that we should address.

We will also address the Microloan Program. We know that microloan lenders, including many of you represented here today, made over 8,000 loans to existing and startup small businesses during the past 4 years, creating more than 34,000 jobs. This is another area where we must build upon the program. I know the SBA has expressed a desire to continue to improve all of its loan programs, and that is based on the fiscal request for this next year. I hope that we can look at some of those issues.

I tried to redirect the 7(a) loan program by reducing the cost by more than 72 percent by using an econometric model. I am disappointed that it was not fully implemented by the SBA and I hope we have an opportunity to discuss that here today and what the obstacles are so that we could have the full benefits of using that model that ultimately could result in thousands of more jobs, because if realized—at least with the STAR Program, where it has

not been used—we could achieve a savings of more than $13 million that could be turned around into millions of dollars of loans.

As we address these and other issues, I hope you will feel free to comment and to submit further comments during the course of the reauthorization process, because we want to do all that we can to elicit your views on what is working, what is not working, and what can we do better.

Why don't we begin? I would like to begin with the 7(a) loan program. I think many of you are familiar with the format that has been utilized here in the past, but you can put your card up to signify the fact that you want to make a comment. I will keep a list of speakers in the order that you put your nameplates up.

I hope that you feel free to comment, and frankly we can start with the 7(a) loan program, but if you want to move in—let us do that first, and then we can move onto microloans and so on. I want to focus on those areas where it matters most.

Before I depart in the next hour, please feel free to comment on those or any other programs that you want to get my attention on.

Who would like to begin? Tony? Please identify yourself. You all know each other.

Mr. WILKINSON. I am Tony Wilkinson. I am the President and CEO of the National Association of Government Guaranteed Lenders, Inc. Our members account for approximately 80 percent of the 7(a) loans that are made annually.

First of all, we want to thank you for your efforts on Senate bill 141, the econometric bill. As you know, Senators Kerry and Bond worked on that bill for a long time and tried to get that situation rectified. You came in and made that your first legislative priority, and we certainly appreciate that.

I also want to thank you for your efforts, with Senator Kerry, to get the leftover STAR money reprogrammed. That is going to be very critical to help meet demand for this fiscal year.

I would like to comment on the Administration's 2004 budget request. Basically it is inadequate for the 7(a) program. Last year we did $12.2 billion gross, $11.1 billion net. They have a budget request for next year of $9.3 billion and that is just not going to work.

We did $5 billion the first 6 months of this fiscal year, even though there was a $500,000 loan cap in place. Historically the second 6 months of the fiscal year has substantially higher volume than the first. We are clearly going to be well ahead of a $9.3 billion pace this year, so the budget request for next year is going to be insufficient.

We fully believe that if we start the next fiscal year with a $9.3 billion program level, that the Administration will have to take steps to limit loan volume in the 7(a) program, and that is something that we hope we can avoid.

We agree with you that the agency has not fully implemented the STAR rescoring. We hope that is another issue that we can get resolved. We believe we will need some of those monies to get through this fiscal year. Even if we are wrong and we do not need it this fiscal year, we obviously need it the next fiscal year. We need to see if we can get that situation rectified.

That action would cost no money. The money is sitting out there. It has already been appropriated. It is a no cost solution to our funding shortfall this year and next. So we hope that the Agency will take a look at that quickly.

Lastly, we know that the Federal Credit Reform Act is going to be reauthorized this year. As a member of the Budget Committee, we would ask that you would take a hard look at what is going on in there. As you know, in our words, the 7(a) subsidy rate was gamed for several years, and I do not know what the Administration has planned in the reauthorization process. We do know that they are looking at putting what we call the master reserve fund in our secondary market, under the Credit Reform Act, which we do not believe they have the legislative authority to do. So that is another issue that we would hope that you would take a close look at.

Our association has a legislative package proposal that we will submit for the record today. With that I am finished.

[The information follows:]

(March 10, 2003)

Legislative Proposal

By

National Association of Government Guaranteed Lenders, Inc.

108th Congress

A BILL

To improve the availability of capital to small businesses under the 7(a) loan program, and for other purposes.

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE. - - - This Act may be cited as the "7(a) Reauthorization and Improvements Act of 2003".

(b) TABLE OF CONTENTS. - - -

Sec. 1. Short title; table of contents.
Sec. 2. Program authorizations.
Sec. 3. National preferred lenders program.
Sec. 4. Secondary collateral.
Sec. 5. Alternative size standards.
Sec. 6. Amount of SBA fees.
Sec. 7. Commercially reasonable fees.
Sec. 8. Pilot programs.
Sec. 9. Loans sold in secondary market.
Sec. 10. Combination loans.
Sec. 11. Implementation.

Sec. 2. Program Authorizations.

Section 20 of the Small Business Act (15 U.S.C. 631 note) is amended by adding at the end the following:

"(m) FISCAL YEAR 2004. - - - For fiscal year 2004 for the program authorized in section 7(a) of this Act, the Administration is authorized to make $16,000,000,000 in deferred participation loans, and there are authorized to be appropriated to the Administration such sums as may be necessary to carry out such program.

"(n) FISCAL YEAR 2005. - - - For fiscal year 2005 for the program authorized in section 7(a) of this Act, the Administration is authorized to make $16,500,000,000 in deferred participation loans, and there are authorized to be appropriated to the Administration such sums as may be necessary to carry out such program.

"(o) FISCAL YEAR 2006. - - - For fiscal year 2006 for the program authorized in section 7(a) of this Act, the Administration is authorized to make $17,000,000,000 in deferred participation loans, and there are authorized to be appropriated to the Administration such sums as may be necessary to carry out such program.

SEC. 3. National Preferred Lenders Program

Section 7(a) of the Small Business Act (15 U.S.C. 636(a)) is amended by adding the following new paragraph at the end thereof.

"(31) NATIONAL PREFERRED LENDERS PROGRAM. - - -

"(A) IN GENERAL. - - - The Administration shall authorize a participant in the preferred lenders program to operate as a preferred lender in any State, providing that such lender meets criteria established by the Administration as provided in this paragraph.

"(B) ELIGIBILITY CRITERIA. - - - The criteria shall include - - -

"(i) demonstrated proficiency in the preferred lenders program for a minimum of three years;

"(ii) annual approvals of a minimum number of loans under the regular loan program as determined by the Administration, excluding loans made under SBA*Express* or Community*Express*;

"(iii) operation in at least five states; and

"(iv) centralized approval, loan servicing and loan liquidation functions and processes which are satisfactory to the Administration.".

SEC. 4. Secondary Collateral.

Section 7(a) of the Small Business Act (15 U. S. C. 636) is further amended by adding at the end of paragraph (1) the following:

"(C) COLLATERAL. - - - Financial assistance shall not be denied under this subsection solely due to inadequate collateral, but a loan shall be secured as fully as possible with available assets. If the assets of the business are not sufficient to fully secure the loan, other assets of the principal owners may be taken as collateral, but the amount of the lien taken on secondary collateral, plus the amount of the lien on business collateral, shall not exceed the amount necessary to fully secure the loan.".

SEC. 5. ALTERNATIVE SIZE STANDARD.

Section 3(a)(3) of the Small Business Act (15 U.S.C. 632(a)(3)) is amended by striking the period at the end thereof and inserting the following: ": *Provided,* That the Administrator shall establish a size standard which shall be applicable to both 7(a) loan applicants and development company loan applicants and which utilizes maximum net worth and maximum net income as an alternative to the use of industry standards.".

SEC. 6. AMOUNT OF SBA FEES.

Section 7(a) of the Small Business Act (15 U.S.C. 636(a)) is further amended - - -

(1) by amending paragraph (18)(A) to read as follows:

"(18)(A) IN GENERAL. - - - With respect to each loan guaranteed under this subsection on or after October 1, 2002 (other than a loan that is

1 repayable in 1 year or less), the Administration shall collect a guarantee
2 fee, which shall be payable by the participating lender, but which may be
3 collected in advance by the lender from the borrower, as follows:
4 "(i) A guarantee fee equal to 1 percent of the deferred participation
5 share of a total loan amount that is not more than $150,000.
6 "(ii) A guarantee fee equal to 2.5 percent of the deferred
7 participation share of a total loan amount that is more than $150,000, but
8 not more than $700,000.
9 (iii) A guarantee fee equal to 3.5 percent of the deferred
10 participation share of a total loan amount that is more than $700,000.";
11 (2) by striking paragraph (18)(C); and
12 (3) by amending paragraph (23)(A) to read as follows:
13 "(23)(A) IN GENERAL. - - - With respect to each loan guaranteed
14 under this subsection on or after October 1, 2002, the Administration shall,
15 in accordance with such terms and procedures as the Administration shall
16 establish by regulation, assess and collect an annual fee in an amount
17 equal to 0.25 percent of the outstanding balance of the deferred
18 participation share of the loan.".
19 **SEC. 7. COMMERCIALLY REASONABLE FEES.**
20 Section 7(a)(22) of the Small Business Act (15 U.S.C. 636(a)(22)) is amended to
21 read as follows:
22

1 "(22) FEES TO LENDERS. - - -

2 "(A) LATE PAYMENT FEE. - - - The Administration shall permit

3 participating lenders to impose and collect a reasonable penalty fee on

4 late payments of loans guaranteed under this subsection in an amount not

5 to exceed 5 percent of the monthly loan payment per month plus interest.

6 "(B) OTHER FEES. - - - The Administration shall also permit

7 participating lenders to impose and collect fees for other services

8 performed for borrowers of loans guaranteed under this subsection

9 providing that the lender normally charges a similar amount for the same

10 services to borrowers of conventional loans. As used in this paragraph,

11 the term 'services' includes, but is not limited to application fees,

12 commitment fees, in-house closing documentation fees, and servicing

13 fees such as for assumptions, name changes, substitution of collateral,

14 release or substitution of a guarantor or similar actions.".

15 **SEC. 8. PILOT PROGRAMS.**

16 Section 7(a)(25) of the Small Business Act (15 U.S.C. 636(a)(25)) is amended by

17 re-designating paragraphs (B) and (C) as paragraphs (D) and (E), respectively, and by

18 inserting prior thereto the following:

19 "(B) DOLLAR LIMITATION. - - - Not more than 5 percent of the total

20 dollar amount of loans guaranteed in any fiscal year under this subsection may

21 be awarded as part of a pilot program: *Provided,* That if a pilot program

22 commenced prior to March 1, 2003, not more than 15 percent of the total dollar

amount of loans guaranteed in any fiscal year under this subsection may be awarded as part of the pilot.

"(C) TERM LIMIT. - - - The duration of any pilot program, including any modifications or changes, shall be limited not to exceed three years: *Provided,* That any pilot program which commenced prior to the effective date of the 7(a) Reauthorization Act of 2003, shall be limited to three years after such date.".

Sec. 9. Loans Sold in Secondary Market

Section 5(g) of the Small Business Act (15 U.S.C. 634(g)) is amended by striking the period at the end of paragraph (1) and inserting: ": Provided further, That the interest rate on loans included in the pool shall be either (A) equal to the lowest interest rate on any individual loan in the pool or (B) the weighted average interest rate of all loans in the pool, subject to such limited variations in loan characteristics as the Administration may deem appropriate to enhance marketability of the pool certificates.".

Sec. 10. Combination Loans.

Section 7(a)(3)(A) of the Small Business Act (15 U.S.C. 636(a)(3)(A)) is amended to read as follows:

"(A) if the total amount outstanding and committed (by participation or otherwise) to the borrower under section 7(a) of this Act would exceed $1,000,000 (or if the gross loan amount would exceed $2,000,000), except as provided in subparagraph (B), plus an amount not to exceed the maximum amount of a development company financing under section 504 of the Small Business Investment Act of 1958 as provided in section 502 of such Act;".

1 **Sec. 11. Implementation.**

2 This Act shall be effective upon enactment, and, if further discretionary actions
3 are necessary by the Small Business Administration to fully implement this Act, the
4 Agency is directed to complete such actions not later than 6 months after the date of
5 enactment.

NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

SUMMARY OF LEGISLATIVE PROPOSAL

108TH CONGRESS

The National Association of Government Guaranteed Lenders (NAGGL) recommends enactment of legislation to make the following changes in the 7(a) loan guarantee program administered by the Small Business Administration (SBA).

1. Loan Program Authorizations --- Authorize the SBA to carry out a 7(a) guaranteed loan program in the following amounts: $16 billion in fiscal year 2004, $16.5 billion in fiscal year 2005, and $17 billion in fiscal year 2006.

2. National Preferred Lenders Program (PLP) --- Direct SBA to establish a national program to permit PLP lenders to operate in any state. Minimum eligibility criteria would include making a minimum number of loans over at least 3 years in at least 5 states, and other demonstrations of proficiency as set by SBA.

3. Secondary Collateral --- Limit the amount of a lien placed on secondary collateral owned by a borrower (e.g., a residence) to the amount needed along with the amount of the lien on business property to fully secure the loan.

4. Alternative Size Standard --- Direct SBA to establish a simple alternative size standard which 7(a) lenders could use to determine eligibility for 7(a) loans (as now exists for use by 504 program) rather than requiring the use of complicated industry standards under NAICS.

5. SBA Fees --- Make permanent the current fee structure (now sunset October 1, 2004). Borrowers would pay SBA a one-time fee of 1%-3.5% based on loan size and lenders would pay 0.25% annually on the amount of the loan outstanding during the life of the loan.

6. Commercially Reasonable Fees --- In addition to late payment fees now authorized, allow 7(a) lenders to charge borrowers normally imposed bank application and commitment fees and fees for specific loan servicing actions requested by the borrower.

7. Pilot Programs --- Limit new loan pilot programs to 3 years duration and to 5% of annual loan program dollars, but allow any existing pilot to continue for 3 years for up to 15% of the program.

8. Secondary Market --- Allow the sale to investors of shares in pools of 7(a) loans with different interest rates in addition to pools with identical rate loans. Pools of loans with similar interest rates would have a weighted interest rate.

9. Combination Loans --- Allow a small business borrower to fully participate in both the 7(a) and 504 programs up to the maximum loan limits for each program.

10. Implementation --- Direct SBA to take such discretionary actions as may be necessary to implement the provisions of this Act within 6 months.

(NAGGL)

(March 10, 2003)

Explanation and Background

The 7(a) loan program provides partial guarantees (generally 75% but 85% on amounts up to $150,000) to reimburse lenders on account of losses on loans to small businesses for plant acquisition, construction, conversion, or expansion, including the acquisition of land, material, supplies, equipment, and working capital.

1. Program Authorizations
(Section 2)

The Small Business Act provides an authorization for the amount of 7(a) loans which may be guaranteed by the Small Business Administration (SBA) each year. Recent Congressional practice has been to provide authorizations for three years. The last bill provided authorizations for fiscal years 2001, 2002 and 2003 of $14.5 billion, $15 billion and $16 billion, respectively.

We believe that it is appropriate to provide loan guarantee levels for three additional years as follows:

- $16 billion in fiscal year 2004,
- $16.5 billion in fiscal year 2005, and
- $17 billion in fiscal year 2006.

2. National Preferred Lenders Program
(Section 3)

The Small Business Act authorizes a Preferred Lenders Program (PLP). Under this program, SBA delegates to eligible lenders the complete authority to make and close loans with a guarantee from the Administration without the lender obtaining the prior specific approval of the guarantee. After making the loan, the lender is also authorized to service and liquidate defaulted loans without the necessity of obtaining the prior specific approval of the SBA for routine servicing and liquidating actions.

In practice, SBA requires a lender to request PLP status in each district in which it desires to operate. Thus even an experienced, proficient lender with PLP status in a dozen states is required to apply for PLP status before it can begin utilizing delegated approval authority in any other state.

Applying for PLP status in each state imposes an administrative burden not only upon the lender but upon SBA staff who must process the application.

We believe that once a lender has proven its ability to function proficiently as a PLP lender, it should be afforded this status in any state where it desires to make loans. We propose that this proficiency be based upon:

- three years' experience as a PLP lender
- in at least five states
- with annual minimum loan requirements in an amount to be determined by SBA
- centralized functions and processes which are satisfactory to SBA.

3. Secondary Collateral
(Section 4)

Sometimes the value of business collateral is not sufficient to fully secure a loan as despite the cost of the property it is generally valued at an amount it would bring on a forced liquidation sale. Thus the Agency requires that the borrower provide other property (such as a home or other buildings) as secondary collateral so that the loan is fully secured.

The amount of required secondary collateral frequently results in the loan being over secured.

For example, on a $700,000 loan, the business collateral may be valued at $500,000. An additional $200,000 in secondary collateral would make the loan fully secured; however, the Agency generally records a lien against the secondary collateral for the entire amount of the loan and not just for the requisite $200,000.

Taking excessive collateral as in this example harms the borrower who is thus deprived of equity in the secondary collateral which might be needed either for personal use or for other business use, such as future working capital to permit growth.

In addition, some states base a recording tax upon the amount of the lien. Thus in our example the borrower will pay a stamp tax based upon a $700,000 loan instead of on the $200,000 shortfall in security.

We believe that SBA loans should be fully secured. This protects both the lender and the Government in the event of default. We do not believe they should be over secured.

We request that the total amount of a lien on all collateral, business and secondary, be limited to an amount which will fully secure the loan.

4. Alternative Size Standard
(Section 5)

In order to be eligible for an SBA business loan, the borrower must meet the definition of small business. Pursuant to the Small Business Act, SBA has promulgated size standards by industry utilizing the North American Industry Classification System or NAICS. Utilization of the SBA table based upon NAICS is very complicated as the table involves over 20 pages of single spaced typewritten material.

As an alternative to these size standards, SBA permits two programs (Small Business Investment Companies and Certified Development Companies) to utilize a simple size standard based upon net worth and net income.

The alternative size standard for Certified Development Companies or 504 lenders is tangible net worth not in excess of $7 million and average net income after Federal income taxes for the preceding two completed fiscal years not in excess of $2.5 million.

We believe that it is only fair that 7(a) lenders be allowed to use this simple test rather than reading columns of codes and determining number of employees or sales, depending upon the industry.

We urge that SBA be directed to adopt a standard for 7(a) lenders to use which is the same permitted to 504 lenders.

5. Amount of SBA Fees
(Section 6)

Due to what has turned out to be erroneous overestimates of subsidy rates, effective with fiscal year 1996 legislation was enacted imposing a substantial increase in borrower fees and a fee was imposed for the first time on lenders. As the subsidy rates have fallen, lower amounts of appropriations were provided rather than reducing the user fees.

But in 2001, Congress enacted P.L. 107-100. Section 6 of that law provided a two-year reduction in user fees during fiscal years 2003 and 2004.

Thus today a borrower pays a one-time fee of:

- 1% on loans up to $150,000
- 2.5% on amounts above $150,000 but not more than $700,000
- 3.5% on amount above $700,000.

The current lender's fee is 0.25% of the amount of the outstanding loan balance each year for the life of the loan.

Now that legislation has been enacted providing for the immediate use of a new subsidy rate model and has resulted in a lower subsidy rate, we believe that the sunset on the fee reductions should be made permanent law.

Finally, we request that the lender be allowed to collect the SBA guarantee fee from the borrower in advance. The current practice is that the lender advances the fee and pays SBA and is then later reimbursed by the borrower. This is a fee which goes in its entirety to SBA to reduce the subsidy rate and it should be paid up front when the borrower files its loan application.

6. Commercially Reasonable Fees
(Section 7)

Except for the guarantee fee which is remitted to SBA, a 7(a) lender may not impose any fee except in the event the borrower makes a late payment. No other fees are permitted even if the borrower requests a specific action by the lender and even though the lender would impose a fee for providing these additional services on regular commercial loans which it makes.

Examples of these fee for services include application fees, commitment fees, in-house closing documentation fees, and servicing fees such as for assumptions, name changes, substitution of collateral, release or substitution of a guarantor or similar actions.

We believe that it is a legitimate business practice for lenders to charge fees for specific services and that it they do so on commercial loans, they should also be permitted to charge a similar amount to a 7(a) borrower.

7. Pilot Programs
(Section 8)

The Small Business Act limits 7(a) pilot programs initiated by SBA to 10% of the total number of loans guaranteed in any fiscal year, except that it grandfathers pilot programs in existence on October 1, 1996. There is no limitation on the dollar amount which may be approved under a pilot program nor is there any term limit on the conduct of pilot programs.

The predecessor of a current pilot program, SBA*Express,* commenced in 1995 and has been extended seven times, with the current pilot due to expire at the beginning of fiscal year 2006. Even though the program commenced with 10 lenders as participants and now encompasses 2,500 lenders and even though the size of loans eligible for the program has increased from $100,000 to $250,000, the SBA maintains

that it is still the pilot which commenced prior to the limitation and thus it is not subject to the statutory limitation.

Last year this pilot approved in excess of one-third of all 7(a) loans by number and almost 7% by dollar. With the recent changes, we expect that both numbers will increase substantially this year. In fact, preliminary data thru February shows that SBA*Express* grown to 47%!

We are not opposed to pilot programs. We applaud the Administration's initiative in testing new ways to fulfill small business financing needs. In fact, we believe that our members deliver most of the loans under this pilot.

We do not believe, however, that a program can continue to exist as a pilot year after year after year. If a pilot is successful, it should become a permanent program and receive its own authorization rather than consuming the regular 7(a) program.

We believe a pilot program should be limited to a maximum term of three years and that it not be permitted to use more than 5% of the 7(a) program level. We would suggest applying these rules to all pilot programs, whether initiated before or after enactment of this limitation, but we would allow a pre-existing pilot to continue for three additional years and to have a higher dollar limitation.

8. Loans Sold in Secondary Market
(Section 9)

The Small Business Act permits lenders to sell the guaranteed portion of a 7(a) loan to a packager who forms "pools" of loans and sells shares in the pool to private investors. This permits lenders to replace the capital they have committed in small business loans and to make even more loans.

Current regulations limit the pools to loans of identical interest rates. This creates a homogeneous pool which is not disproportionately affected by the default or prepayment of one or a few loans, and is attractive to investors.

There are, however, some loans which are outside the identical rate patterns now being sold. This disparity causes them to loose marketability or may greatly decrease their value.

We favor continued marketing of pools with identical interest rates. We believe, however, that there is a market for loans with some variation in interest rates. Formation of such a pool would have a weighted interest rate and would provide liquidity in these loans.

Weighted interest rate pools should be attractive to investors as long as they had substantially similar characteristics as determined by the Agency.

9. Combination Loans
(Section 10)

In previous times, both 7(a) loans and 504 financings were subsidized by appropriated funds to pay losses. It was thus appropriate to restrict small businesses to a choice between the two programs. This mandated choice, however, has caused problems for larger small businesses which need funds from both programs but are limited to a combined amount not to exceed $1 million under 7(a) or $1 million or $1.3 million under 504 if the borrower is filling a public policy goal.

Government financial support for these programs has been substantially reduced. The 7(a) program currently has a subsidy rate of only 1% and the 504 program is self-supporting. It thus appears that the mandated choice of one or the other is no longer necessary and imposes unneeded restrictions on small business borrowers.

We believe that this restriction should be removed and a borrower permitted to receive assistance under both the 7(a) and 504 programs to the maximum amount permitted under each program.

10. Implementation
(Section 11)

SBA, on occasion, has not been prompt in making decisions needed to implement legislation, thereby denying small businesses the timely benefits it was intended to provide.

We believe that it would be appropriate for the Congress to indicate its position that the Agency should take such discretionary action as is needed to fully implement the provisions of this Act within 6 months.

(NAGGL)

(March 10, 2003)

7(a) REAUTHORIZATION AND IMPROVEMENTS ACT OF 2003

SECTION BY SECTION ANALYSIS

Section 1. Short title; Table of contents

Subsection (a) provides that this Act may be cited as the 7(a) Reauthorization and Improvements Act of 2003.

Subsection (b) provides a table of contents for the Act:

Sec. 1. Short title; table of contents.
Sec. 2. Program authorizations.
Sec. 3. National preferred lenders program.
Sec. 4. Secondary collateral.
Sec. 5. Alternative size standards.
Sec. 6. Amount of SBA fees.
Sec. 7. Commercially reasonable fees.
Sec. 8. Pilot programs.
Sec. 9. Loans sold in secondary market.
Sec. 10. Combination loans.
Sec. 11. Implementation.

Sec. 2. Program Authorizations.

Section 2 amends section 20 of the Small Business Act by adding three new subsections:

proposed subsection (m) authorizes $16,000,000,000 in deferred participation loans in fiscal year 2004;

proposed subsection (n) authorizes $16,500,000,000 in deferred participation loans in fiscal year 2005; and

proposed subsection (o) authorizes $17,000,000,000 in deferred participation loans in fiscal year 2006.

SEC. 3. National Preferred Lenders Program

Section 3 amends section 7(a) of the Small Business Act by adding a new paragraph (31)(A) directing the Administration to authorize participants in the preferred lenders program to operate as a preferred lender in any state, providing that the lender meets criteria established by the Administration.

Proposed paragraph (31)(B) enumerates eligibility criteria, including - - -

(i) demonstrated proficiency in the PLP program for at least 3 years;

(ii) annual loan approvals of a minimum number of general 7(a) loans to be determined by the Administration, but excluding SBA*Express*;

(iii) operation by the lender in at least 5 states; and

(iv) centralized approval, loan servicing and loan liquidation functions and processes which are satisfactory to SBA.

SEC. 4. Secondary Collateral.

Section 4 amends section 7(a) of the Small Business Act by adding a new paragraph (C) at the end of paragraph (1).

The proposed language would provide that if the assets of the business are not sufficient to fully secure the loan, other assets of the principal owners of the borrower may be taken as collateral; however, the amount of the lien taken on the secondary collateral plus the amount of the lien on the business collateral shall not exceed the amount necessary to fully secure the loan.

SEC. 5. ALTERNATIVE SIZE STANDARD.

Section 5 amends section 3(a)(3) of the Small Business Act by adding a *proviso* that the Administrator of SBA shall establish a size standard which shall be applicable to both 7(a) loan applicants and development company loan applicants which utilizes maximum net worth and maximum net income of the prospective borrower as an alternative to the use of industry standards.

SEC. 6. AMOUNT OF SBA FEES.

Section 6 amends section 7(a) of the Small Business Act to make permanent the current fee structure- - -

(1) by re-wording section 18(A).

The proposed paragraph (18)(A) would require the borrower to pay in advance of loan approval a one-time fee as follows:

(i) 1% if the amount of the loan does not exceed $150,000;

(ii) 2.5% of the amount of the loan which exceeds $150,000 to $700,000; and

(iii) 3.5% of the amount of the loan which exceeds $700,000.

(2) by striking paragraph (18(C); and

(3) by re-wording paragraph (23)(A).

The proposed (23)(A) would require a lender to pay an annual fee of 0.25% or the amount of the outstanding balance of the loan.

SEC. 7. COMMERCIALLY REASONABLE FEES.

Section 7 would amend section 7(a) of the Small Business Act by re-wording paragraph (22).

Proposed paragraph (22) would authorize a lender to impose new application and commitment fees and also fees for services requested by 7(a) borrowers providing that the lender normally charges a similar amount for the same services to borrowers of conventional loans.

SEC. 8. PILOT PROGRAMS.

Section 8 amends section 7(a)(25) of the Small Business Act by re-designating existing paragraph numbers and by adding new paragraphs prior thereto.

The proposed paragraph (B) would limit 7(a) pilot programs to an amount not to exceed 5% of the annual amount approved each fiscal year, except that an existing pilot program would be allowed up to 15% of the annual program level.

The proposed paragraph (C) would limit the duration of any 7(a) pilot program to 3 years, except any pilot program which commenced prior to the effective date of this Act would be limited to three years after that date.

Sec. 9. Loans Sold in Secondary Market

Section 9 would amend section 5(g) of the Small Business Act by inserting a proviso at the end.

The proposed language would allow loan pools to be comprised of loans with various interest rates and the pool would have an interest rate of the weighted average of such loans. SBA would prescribe the maximum amount of variation in the loan characteristics in order to enhance marketability of the pool.

Sec. 10. Combination Loans.

Section 10 would amend section 7(a)(3) of the Small Business Act by re-wording paragraph (A).

The proposed language would authorize a small business to borrow up to the maximum deferred participation share of a 7(a) loan plus the maximum amount of a debenture guarantee as provided for the 504 program under section 502 of the Small Business Investment Act of 1958.

Sec. 11. Implementation.

Section 11 provides that the Act is effective on enactment and that if further discretionary actions are necessary by the SBA, the Agency shall complete them not later than 6 months after the date of enactment.

Chair SNOWE. Thank you very much, Tony.

At some point, Ron, I would like to have you comment on some of these issues because it is important, I think, to talk about the Administration's proposal.

Mr. BEW. Do you want me to comment now?

Chair SNOWE. Yes, why don't you and then we will go on to hear your view on both of the issues he raised. That would be helpful.

Mr. BEW. The Administration feels that the 2004 budget is adequate at $9.3 billion. It is basically in line with historic numbers. We went back over the last 4 years and it has always been $9 billion. You have to accept the fact that $11.1 billion includes the STAR appropriation which was a supplemental appropriation, and just a one time event.

We are running about $37 million on a daily basis now, and that is in line, if you multiply it times 251 days, we are at $9.3 billion.

Mr. WILKINSON. Is that a year-to-date daily average?

Mr. BEW. That is actually over the last 3 years. I think 2000, 2001, 2002. It was running about $37 million a day.

Mr. WILKINSON. What we typically see happen is—let us just take last year. We did $5.1 billion the first 6 months. The last 6 months was $7.2 billion. The last half of the fiscal year, there usually is at least $1 billion growth. Last year it was a $2 billion growth.

I want to be cautious about whether they are using a historic loan volume for 3 years, because that does not match what happened the last 6 months of last year and is probably not going to match what will happen this year.

Chair SNOWE. Would most of you agree on that point?

Mr. BEW. The $37 million is the average for the whole year. Sometimes we hit under $20 million in the early months.

Mr. WILKINSON. There is a definite cycle to the 7(a) program. The second half is much larger than the first.

Chair SNOWE. Is that most of the experience here, would you say?

Mr. BARTRAM. Yes.

Chair SNOWE. Steve.

Mr. BYRNES. Good morning, Senator Snowe. My name is Steven Byrnes. I manage small business lending for a lender in Maine.

In order to maintain our position in the State of Maine as the number one SBA lender, there are two programs I would like to advocate for continuing and expanding. One is the Preferred Lender Program, which Fleet participates in. Since 1998, that has been expanded from 1 lender in the State to 11, and I think, is largely attributable to the increase in the SBA volume throughout Region I.

Secondly, I would also like to advocate for the continued expansion and support of the SBA Express Program. That has really been the key to our success as far as driving more capital into the hands of small business. Prior to 1998 and that program roll-out we made 10 SBA loans in the entire State of Maine. Two years after SBA Express and PLP status was established, we made 137 SBA loans. So more than a ten-fold increase in our activity in SBA Express.

Chair SNOWE. What precisely made the difference in this Express Loan Program?

Mr. BYRNES. Ninety percent of our SBA Express Loan approvals were scored less than $100,000. We were able to allow our clients, with a 1-page application, to score their approvals, a credit score. Based on that we were able to approve the loan, document it, close it, and hopefully not liquidate it but we can liquidate it. It gave the bank a lot of the authority to manage the process on behalf of the client with the authority from the SBA, and we have been very successful managing that.

I think, to your point, there are three key benefits to the SBA Express. It reduces the paperwork, it streamlines the process, and significantly reduces the closing costs because the bank does not have to hire legal counsel to prepare the documents which under traditional 7(a) can be fairly complicated and have a lot of regulations and requirements. Our own in-house documents and our centralized SBA underwriting group allows us to be very efficient. We approve those loans in less than 48 hours because we credit score them.

It really is a very efficient process and I would like to continue to advocate for that.

Chair SNOWE. It is good to know that it is working well. That makes a difference, when you make those changes, that you see the end result and it is positive.

Mr. BEW. May I make a comment on that?

We are very proud of the changes we made to Express. When I got here, I guess a little over 12 or 13 months ago, the Administrator asked me to dramatically expand the number of loans that we make and really to touch more businesses. Which in essence, even though we focus on number of loans, (7a) is really a job creation program. He wanted me to drive down that average loan size and Express was a way to do it.

So we made a couple of changes. One, we increased it from $150,000 to $250,000, and then we opened it up to 2,400 banks that could qualify for it. I think we have about 500 new banks that joined the program.

It is an important point to realize, these banks are taking a 50 percent guarantee and not the normal 75, 85 percent. That is how positive they felt about the program and the cost of delivering the normal 7(a) programs.

We have doubled our volume and we have also, by driving down the average loan size primarily with Express, really increased our minority lending. We have a chart here to get a little plug in for Express, since you brought it up.

This is one I used in the House and updated it. Minority lending year-to-date, almost 7 months into the year, is up 43 percent overall. And in the categories, African-American is really up at 68 percent, and women are up 37 percent. We think there is a correlation between the average size of the loan, the smaller loan, and startups and minority lending. It was always thought to be that way and I think the numbers are starting to prove it to be. So it is part of our philosophy to drive down the average loan size.

Chair SNOWE. I think that is obviously a very positive development. Is there outreach in this process, too? Is that what also happens? What accounts for the increase? Do people come through the door and then they realize this is going to be a much easier proc-

ess? How do they learn about the Express Loan Program? Or is it just when they come through the door that they find out it is not going to be as difficult as they might have thought?

Mr. BEW. We market directly to the banks on the Express Program. You can maybe address that, Steve.

Mr. BYRNES. We market the Preferred Lender Program status. We actually put the preferred lender status on the front of all of our doors of all of our branches. When we sit down with a client and they may have been talking with two or three banks, the fact that we are a preferred lender allows us to put it through in a much faster streamlined process. So the clients tend to gravitate towards our institution.

Outside of the normal day-to-day sales activities that usually comes in the door, we do not specifically market against it except for the PLP program.

Chair SNOWE. The point is that a lot of people came through the door that otherwise would have been denied, or they did not want to be hassled with the process.

Mr. BYRNES. Correct.

Chair SNOWE. But once they were familiar with this process, it made it much easier because you could process it without having to use the SBA, and had greater authority to exercise the ability to process this loan.

Mr. BYRNES. The key is the underwriting side. We were able to expand the credit score to capture a larger audience of clients that may have been declined without the guarantee. That was the key.

Chair SNOWE. That is the key.

Ms. FORBES. I wanted to follow up. Ron, I noticed your chart combines 7(a) and 504. Is it possible for you to submit for the record breakdown of 7(a) and 504?

Mr. BEW. Sure.

Ms. FORBES. I think we would all be interested in that.

Chair SNOWE. Dave.

Mr. BARTRAM. Senator Snowe, thank you very much for having me here today. I certainly appreciate the opportunity.

I am Dave Bartram, President of the SBA Division, U.S. Bank.

I will give you a little bit of background on our bank. We currently have an outstanding SBA loan portfolio of $1.6 billion and almost 6,000 loan customers in the SBA program. I personally have been active in the SBA program for over 20 years.

I am here today also as the Vice Chairman of the National Association of Government Guaranteed Lenders.

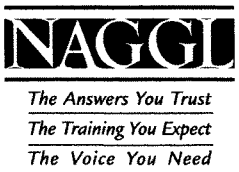
I want to certainly echo what our President has stated, that the Administration's request for the 2004 program level is short, and we believe short around 25 percent, and do we believe that with a $9.3 billion program level that the SBA will be forced to do some sort of rationing, which basically is a loan cap.

I believe that most lenders are expecting to lend more, not less. That, in my mind, supports the fact that we need more funding not less. Our bank is expecting a 20 percent loan increase, which is in line with what the trade association is also stating.

I would like to, if I could, put into the record my testimony in the House. It basically outlines 10 points of the legislative proposal that the trade association has.

Chair SNOWE. Absolutely. It will be included in its entirety in the record.

[The prepared statement of Mr. Bartram follows:]



Testimony for the House Committee on Small Business

David H. Bartram

Vice Chairman
The National Association of
Government Guaranteed Lenders, Inc.

And

President - SBA Division
US Bank

March 20, 2003

Thank you for the opportunity to testify. I am David H. Bartram, President of the SBA Division of US Bank. The SBA Division of US Bank currently has an outstanding portfolio of approximately $1.6 billion and over 5,500 SBA loan customers. I have been active in SBA lending for more than 20 years, working in both large and small banks.

I am also the vice chairman for government relations of The National Association of Government Guaranteed Lenders, Inc. ("NAGGL"). NAGGL is a trade association for lenders and other participants who make approximately 80 percent of the Small Business Administration ("SBA") section 7(a) guaranteed loans. The SBA's 7(a) guaranteed loan program has proven to be an excellent public/private partnership. Over the last decade, the SBA has approved more than 450,000 loans for almost $100 billion. We thank the Committee for the opportunity to comment on the SBA 7(a) program.

Since the beginning of "Credit Reform" in 1992, the SBA 7(a) subsidy rate has fallen from a high of 5.21 to the budget level for FY 2004 of 1.02. This represents a more than 80% reduction in the estimated cost of the program to the government. This reduction in subsidy costs has been achieved by improved underwriting guidelines, establishment of lender review procedures, and fee increases on both borrowers and lenders.

There are many positive attributes of the SBA 7(a) loan program, including:

- SBA loan programs provide approximately 40% of all long-term loans (loans with maturities of three years or longer) to small businesses. The SBA is the largest single provider of long-term loans to small business.

- SBA estimates that recipients of 7(a) loans in 2002 created or retained 370,000 jobs.

- SBA 7(a) loans that may not create new jobs, assist small businesses in becoming more efficient by allowing them to invest in new plant and equipment. This is especially true for manufacturers, thus retaining production and jobs in the United States by being more globally competitive.

- SBA 7(a) loans have significantly longer maturities than conventional loans to small businesses. The average original maturity of an SBA 7(a) loan, according to the Office of Management and Budget ("OMB"), is 14 years. By comparison, only 16% of conventional small business loans have maturities in excess of one year, and of those loans, the average maturity is less than four years.

- Longer maturities mean substantially lower monthly payments for borrowers. For example, the difference in monthly payments for a 10 year SBA 7(a) loan compared to a five year conventional loan (which would be above the average maturity for conventional loans), would be 35-40%. This is a significant monthly cost savings for the average SBA borrower who tends to be a new business startup or an early stage company. Companies like manufacturers, which purchase capital equipment, have a cash flow benefit from the longer loan maturities offered by SBA 7(a) loans.

- Small businesses do not have the same access to debt-capital as do large businesses. The SBA programs bridge that capital gap.

- The SBA 7(a) appropriations are leveraged almost 99 to 1 by the private sector, making this one of the governments' best and most affordable economic development instruments.

- The SBA 7(a) loan program is just that – a loan program – which helps qualified small businesses obtain the long-term loans they need for growth and expansion. This means jobs, and a "net return on investment" for our local communities and the US Treasury.

Fiscal Year 2004 Budget Request and STAR Loans

STAR Reprogramming. We are deeply disappointed to learn that the SBA will NOT re-score STAR loans, using the new econometric model, made this fiscal year before the expiration of the program on January 10, 2003. Clearly, STAR loans are 7(a) loans, since the terms and fees are identical to 7(a) loans made this fiscal year, and S. 141 provides for the econometric model to be used ***retroactive to October 1, 2002***. We believe these loans should be re-scored, and we ask Congress to vigorously pursue this issue, in order to free up much needed budget authority that could be used to fund loans for the balance of this fiscal year. Without the re-scoring of STAR loans made this fiscal year, there is a strong likelihood that the SBA will not have sufficient 7(a) loan funds to meet demand for the balance of this fiscal year.

FY 2004 Budget Request. The Administration has requested only a $9.3 billion program level for FY 2004. The requested level is far below the estimated level of demand of $12.5 billion. The level of SBA 7(a) program usage (including STAR loans) the last several years is as follows:

1999	$9.5 Billion
2000	$9.7 Billion
2001	$9.1 Billion
2002	$11.1 Billion
2003	$11.8 Billion (estimated)
2004	$12.5 Billion (projected)

The Administration's requested FY 2004 program level would be more than 25% below the projected level of demand. A $9.3 billion program would most likely result in the SBA rationing credit, something that the leadership of this Committee has already objected to for the current fiscal year. Chairman Manzullo recently stated "the $500,000 cap, installed last October, has prevented many small businesses from securing the capital they need to expand and create new jobs." We agree. A FY 2004 SBA 7(a) loan program of only $9.3 billion would likely lead SBA to impose loan size caps again next October.

Small businesses continue to need access to long-term capital. NAGGL requests your support of sufficient appropriations to fund a $12.5 billion 7(a) program for FY 2004. Loan volume for FY 2003 is running ahead of the FY 2002 pace, even though a $500,000 loan cap has been in place (See Attachment A). Given the nature of our economy, we believe that the increase in borrower demand will continue into FY 2004. The Administration's proposed program level of $9.3 billion will be insufficient to meet borrower demand. With your support of a $12.5 billion 7(a) program in FY 2004, we hope to avoid the need to put loan size caps in place again.

For whatever reason, the Administration continues to say that the FY 2004 requested 7(a) program level is "in line with historical usage." We all know that "history" changed on September 11, 2001. The SBA, in response to Committee questions, says 9/11/2001 "was a one-time event that was funded through a supplemental appropriation." Clearly, the impacts of 9/11/2001 continue to have an impact on small businesses. Today, the economy continues to operate at a level far below the economic levels prior to 9/11/2001. Lenders have tightened their conventional credit standards. Many small businesses that used to be able to qualify for conventional credit now find they must turn to the SBA loan programs for assistance.

As a result, 7(a) loan volume has been increasing. During FY 2002, $11.1 billion in 7(a) loans were made. For FY 2003, 7(a) lending is slightly ahead of the FY 2002 pace, even though there was a $500,000 7(a) loan cap in place for the first five months of the fiscal year. Absent the cap, loan volume this fiscal year would be farther ahead of last years.

The relevant history for borrowers, who will need access to long-term credit through the 7(a) program, is post 9/11/2001. Loan demand last fiscal year was $11.1 billion, and we anticipate as much as $11.8 billion this year and $12.5 billion in FY 2004.

Subsidy Rate Impact. In another answer to a Congressional question, the SBA stated that replacing large/longer maturity loans with SBA Express loans would not impact the subsidy rate. We disagree. Since loans over $700,000 pay substantially higher guarantee fees (currently 1% on loans up to $150,000, but 3.5% on loans over $700,000), eliminating large loans from the mix of 7(a) loans puts upward pressure on the subsidy rate. Without larger loans, the subsidy rate will either rise and more money will have to be appropriated to cover the estimated income not collected by loan fees, or costs/fees to borrowers would have to rise. Knowing that the OMB has already overcharged users of the 7(a) program well over $1 billion in the last ten years, further fee increases on borrowers would be unconscionable.

Loan term also plays an important role in the subsidy rate. Longer term loans (15-25 years) have much lower repurchase or default rates than do loans with shorter maturities (7 years or less). Smaller loans are most likely short term loans, while many of the large loans are real estate loans with longer maturities. From data provided by the SBA Chief Financial Officer (CFO) as of 11/30/2002, the following repurchase or default rates highlight that larger/longer maturity loans have much lower purchase rates than do smaller/lower maturity loans:

Cohort	Maturity < 7 years Purchase Rate	VS.	Maturity > 15 years Purchase Rate
1992	19.68%		9.65%
1993	16.87%		6.85%
1994	19.02%		5.12%
1995	20.65%		5.17%
1996	20.71%		6.44%
1997	20.09%		5.31%
1998	19.33%		5.47%
1999	14.46%		5.66%
2000	7.55%		3.55%

Loans made prior to FY 1999 have gone through the "peak of the default curve", meaning a significant portion of the defaults in any given cohort has occurred. For every cohort since 1992, the default or repurchase rate on longer term loans has been less than one-half of default rate of shorter term loans.

Because larger loans pay the highest guarantee fees, and because the longer maturity loans have lower repurchase rates, ***larger and/or longer term 7(a) loans subsidize the cost of smaller, shorter term loans***. Any time the SBA says they want to concentrate on smaller loans (as they do in the FY 2004 budget) or perhaps move 7(a) real estate loans to the 504 program (as they did in the FY 2003 budget), they should also disclose to Congress that those actions will cause the subsidy rate to rise. Properly funding this program is equally important to small 7(a) borrowers as it is to borrower seeking larger loans. The fees of smaller borrowers would likely have to rise if the fees/lower repurchase rates of larger/longer maturity loans are not part of the 7(a) mix.

Credit Crunch. The National Association of Manufacturers is already indicating its members are being faced with a credit crunch. Many times, manufacturers need sizable loans for plant and equipment needs, as well as for working capital. For example, Schilke Music, an established Chicagoland-area musical instrument manufacturer recently borrowed $1,275,000 under the SBA 7(a) program for plant and equipment. Due to the financing package, the borrower was able to preserve 20 high-quality jobs, and was able to obtain loan terms that better fit their cash flow.

R. Scheinert and Sons of Philadelphia, PA repairs industrial motors, generators, pumps and transformers. The company sells to large manufacturers, mechanical contractors, steel plants and food processors. The normally profitable company was negatively impacted by the events of 9/11 and the subsequent soft economy. Thanks to an $825,000 SBA 7(a) loan the company was able to refinance their debt, consolidate accounts payable and provide working capital. The business is now back on track, and 25 jobs were retained.

This would be the wrong time to limit small business financing. The Administrations' inadequate budget request could cut off the borrowing capabilities of many businesses, like manufacturers, who will need larger SBA 7(a) loans next year. In order to preserve jobs and avoid loan caps next fiscal year, a $12.5 billion program level will be needed in the SBA 7(a) program.

Reauthorization Bill

Legislative Request. The National Association of Government Guaranteed Lenders (NAGGL) recommends enactment of legislation to make the following changes in the 7(a) loan guarantee program administered by the Small Business Administration (SBA).

1. **Loan Program Authorizations** - - - Authorize the SBA to carry out a 7(a) guaranteed loan program in the following amounts: $16 billion in fiscal year 2004, $16.5 billion in fiscal year 2005, and $17 billion in fiscal year 2006.

2. **Pilot Programs** - - - Limit new loan pilot programs to 3 years duration and to 5% of annual loan program dollars, but allow any existing pilot to continue for 3 years for up to 15% of the program.

3. **Secondary Collateral** - - - Limit the amount of a lien placed on secondary collateral owned by a borrower (e.g., a residence) to the amount needed along with the amount of the lien on business property to fully secure the loan.

4. **SBA Fees** - - - Make permanent the current fee structure (now sunset October 1, 2004). Borrowers would pay SBA a one-time fee of 1%-3.5% based on loan size and lenders would pay 0.25% annually on the amount of the loan outstanding during the life of the loan.

5. **Alternative Size Standard** - - - Direct SBA to establish a simple alternative size standard which 7(a) lenders could use to determine eligibility for 7(a) loans (as now exists for use by 504 program) rather than requiring the use of complicated industry standards under NAICS. Because of the different size standards, a borrower may be able to obtain fixed asset financing under the 504 loan program, but not be eligible for a working capital loan under the 7(a) program.

6. **Commercially Reasonable Fees** - - - In addition to late payment fees now authorized, allow 7(a) lenders to charge borrowers normally imposed bank application and commitment fees and fees for specific loan servicing actions requested by the borrower.

7. **Secondary Market** - - - Allow the sale to investors of shares in pools of 7(a) loans with different interest rates in addition to pools with identical rate loans. Pools of loans with similar interest rates would have a weighted interest rate.

8. **Combination Loans** - - - Allow a small business borrower to fully participate in both the 7(a) and 504 programs up to the maximum loan limits for each program.

9. **National Preferred Lenders Program (PLP)** - - - Direct SBA to establish a national program to permit PLP lenders to operate in any state. Minimum eligibility criteria would include making a minimum number of loans over at least three years in at least 5 states, and other demonstrations of proficiency as set by SBA.

Thank you for the opportunity to testify. We look forward to working with the members of this Committee and Committee staff on the upcoming SBA re-authorization bill.

Attachment A

SBA –7(a) BUSINESS LOAN APPROVAL (Gross $) YTD FY 2001 VS 2002 VS 2003

PERIOD ENDING: 02/14/03

AMOUNTS ROUNDED TO NEAREST $1,000

	---- FY 2001 YTD ----				---- FY 2002 YTD ----				---- FY 2003 YTD ----			
	# LNS	%	$ APPV	%	#LNS	%	$ APPV	%	#LNS	%	$ APPV	%
7 (a) Loans	13,660		3,132,471		15,184		3,647,269		21,230		3,702,416	
Minority	3,509	26	942,470	30	3,943	26	1,104,191	30	5,660	27	1,126,965	30
African American	648	5	118,994	4	608	4	116,713	3	1,040	5	102,373	3
Hispanic	1,023	7	191,641	6	1,154	8	222,417	6	1,614	8	219,233	6
Asian	1,647	12	597,302	19	1,936	13	717,611	20	2,587	12	747,981	20
Native American	161	1	25,923	1	179	1	37,579	1	221	1	29,758	1
Undetermined	23		9,762		65		25,155	1	179	1	44,958	1
Women	2,980	22	535,375	17	3,124	21	592,069	16	4,309	20	598,140	16
Pre-Qual												
Int. Trade	251	2	86,139	3	208	1	74,738	2	358	2	88,154	2
EW/IT/EE	151	1	59,598	2	137	1	52,786	1	112	1	31,206	1
Veterans	1,492	11	327,733	10	1,618	11	397,604	11	2,159	10	359,405	10
Under $150K	8,394	61	618,979	20	9,378	62	682,271	19	15,269	72	874,328	24
LowDoc	2,824	21	226,934	7	2,913	19	247,974	7	3,052	14	271,120	7
PLP Loans	4,491	33	1,705,882	54	4,841	32	1,979,940	54	4,988	23	1,952,112	53
SBA Express	3,338	24	183,507	6	4,323	28	222,684	6	9,753	46	434,068	12
CLP Loans	451	3	182,947	6	427	3	190,561	5	395	2	158,235	4

Mr. BARTRAM. I would like to highlight, if I could quickly, just 3 of the 10 points.

We would like to see the SBA directed to establish a simple alternative size standard, as now exists with the 504 program, rather than the very complex and exclusive size standard that is now being used for 7(a) loans.

Presently, a client could receive a 504 loan for fixed asset purchases, but may not qualify for a 7(a) working capital loan, which just does not seem right. There are two SBA programs and the size should be the same.

Secondly, I would like to see the current fee structure that will sunset 10/1/04 made permanent. Clients would pay the SBA a one-time fee of between 1 and 3.5 percent, based on the loan size. Lenders would pay an ongoing fee of .25 percent to the SBA on the outstanding loan balance.

Lastly, instruct the SBA to limit the lien on secondary collateral to a more reasonable equity amount. Presently, we have to file a lien on secondary collateral, which typically is the client's home, and we have to file that for the amount of the loan amount. The problem with that is it increases costs to our clients. In some states, they are taxed on the size of the lien, which is far in excess of the amount of equity that they have in their home.

Again, I appreciate the opportunity to be here and I would like to participate.

Chair SNOWE. Thank you. Do you have any comments?

Mr. BEW. David, you will be happy to know that we have a study underway now to look at size standards. It is not in my area but it is ongoing on the collateral issue. The study is making its way through the bureaucracy of the SBA.

The other one, the 2004, that would be under review.

Mr. BARTRAM. Ron, thank you.

Mr. SCHUSTER. Madame Chair, I am Deryl Schuster with Business Loan Express, the Nation's largest 7(a) lender. Thank you for this roundtable.

We are a preferred lender in 68 SBA offices, including Maine and Massachusetts. We are proud to be involved in those states.

During the Nixon/Ford days, I spent 8 years as District Director and Regional Director of SBA. I am a past Chairman of NAGGL and a past Chairman of the ABA Small Business Committee. I can boast of receiving the SBA's District Office of the Year Award and, on the other side of the desk, the National Small Business Banker of the Year recognition at one time.

With these experiences, I was given the responsibility of obtaining and retaining PLP authority for our company. I have got to tell you, if Senator Proxmire was still alive today, one of his infamous awards would go to the SBA for the manner in which the PLP program renewal and expansion is administered. It has got to be one of the most wasteful and unnecessary and frustrating experiences in all of Government.

Let me just cite a few negatives of the current procedures. It has driven several good lenders from the SBA loan participation. It makes a mockery of SBA's lender examination results. It discourages lenders from committing resources to the loan programs. It has opened the door for some SBA officials to blackmail lenders

based upon national performance data. A lender can be the most outstanding lender and still not be approved as a preferred lender. In fact, a lender has to prove and reprove themselves as many as 80 times every 2 years. It makes it very difficult for a lender to market the SBA's loan programs.

Just one of NAGGL's 10 legislative issues is a national PLP program. It is sorely needed in the industry and would favorably impact most all aspects of the 7(a) program.

Chair SNOWE. What would you recommend? Certain standards and criteria?

Mr. SCHUSTER. Some very stringent standards.

Chair SNOWE. A lengthier process for approval, that you would not have to go through a review process?

Mr. SCHUSTER. NAGGL's legislative package does include a detail of what we would propose, and it would include a very stringent set of criteria that a lender would have to meet as it relates to operational criteria on a national basis. We think those criteria should be very stringent. It includes—I do not have that right now, but you would have to have done so many loans in at least five states. Performance criteria—Tony you might—

Mr. WILKINSON. It is in our legislative package, but we believe the Administrator should come up with a stringent set of standards that a preferred lender would have to meet. But it would be administered at a national level rather than having to go to each individual district office and meet each individual district office's requirements, as opposed to here is a national level and if you are performing at the levels set out by the Administrator, then you should be PLP, wherever you choose to lend.

Mr. BALLENTINE. Good morning, Madame Chair, James Ballentine with the American Bankers Association.

I wanted to echo the comments of both Tony and David regarding the appropriations for the 7(a) program. We are particularly concerned about the appropriation process in light of the fact that SBA has proposed to expand the number of lenders within the 7(a) program. In the usual case, more lenders means more loans, which means you need more dollars. In this case, it seems the pot is shrinking while the number of lenders is increasing.

We would ask SBA, as it operates this unique 7(a) program that has a private sector/public sector/lender/partner relationship, that a much more open dialogue be set up amongst the lenders, amongst their partners as they call them, to not only set the appropriations process but also work to see how we can work to make the program work better.

We are concerned that the SBA is becoming not the Small Business Administration but the very small business administration, and that they are attempting to, as Ron says, drive down the size of the loans and at the same time serve all markets.

I think Chairman Manzullo said it best when he said there is a certain sector of the small business community that needs not a very small business loan, but rather, a larger small business loan. That type of capitalization is needed for those businesses that are expanding and that are in their fifth, sixth, seventh, and eighth year. We would really ask that the SBA become a little more open in its process and working with its lending partners to really see

what the adequate funding level is for this program going forward, particularly as they expand the number of lenders.

Chair SNOWE. Is there a possibility of doing something like that, Ron? I do not know historically what has been the case, working with——

Mr. BEW. As far as the dialog?

Chair SNOWE. Yes.

Mr. BEW. I think the very first couple of months when I arrived we had a bankers roundtable. We have probably done five or six. That very first one was really the genesis of expanding the SBA Express Program, so we normally keep those groups to around 10 or 12 bankers at a time. We can continue to do that. The Administrator asked me to continue to do that.

Chair SNOWE. I think that would be worthwhile and I encourage that, because it is helpful and obviously you get some good ideas from the process in trying to improve upon it.

But also in the case here about the budget and the amount of 7(a) loans and the fact that you are going to have more lenders participating, smaller loans, and so on, about the need. Our inability to meet the need or to fulfill the ability for the number of loans that could be processed if we had more authority to do so. Can you address the number?

Mr. BEW. Yes, the numbers are going on. A lot of those 500 that have joined, mainly under the Express, are really doing the smaller loans so it does not eat up that much volume. We still anticipate we can serve the larger banks and lenders, the larger loans as well as the smaller ones.

Chair SNOWE. Why was there not a greater request made for the 7(a) loan program? Obviously, there is a need. It would be utilized. It would make sense, given the fact that—especially in this sluggish economy. Would it not make sense?

Mr. BEW. Again, I think it is adequate that what we requested is in historic lines. We have also found, through a Department of Labor study that looked at our portfolio, that the smaller loans generate more jobs. So as far as the economy, it meshes. They broke down our portfolio a couple of years ago and it showed in loans from 0 to $50,000 it takes $14,000-plus of a loan to create one job. In the loans over $1 million it takes $140,000. So, it is more effective on the smaller loans for the job creation. That has been our track so far.

Mr. BALLENTINE. I think one of the important parts, and I have heard that cited a couple of times, is that there is job creation and there is also job retention, as it relates to making the loans that are needed for small businesses. So every loan is not for a startup small business, but there are loans made for job retention as well.

Mr. HEARNE. Good morning. Thank you for having me.

I am here with the Credit Union National Association, and I want to thank you for inviting us and giving me the opportunity to not only speak but to see so many of my old colleagues from the SBA days.

I used to work at SBA back until 1997, in the Office of the Chief Financial Officer, back when my good friend Mr. Criscitello was Chief Financial Officer.

I am also the Treasurer of Lafayette Federal Credit Union, which among its field of memberships, the SBA is one. Finally, I am also a small businessman and a small business borrower, and I have been through the SBA 7(a) borrowing process from that end, also.

I would like to piggy-back on what some of my colleagues here have said. As you know, the SBA recently adopted a rule that allows credit unions more full participation in the process. We believe that that is going to go a long ways towards not only increasing access to capital but the credit unions themselves have an average loan size of under $100,000. I think it allows more participants.

In addition to that, on the funding side of things, like everyone, more money is better just like I think more lending participants is better. But an important thing, I think, sometimes gets overlooked is just the act of applying for an SBA loan does a lot of what some of the Microloan Program is aimed towards, which is counsel the borrowers. Going through the process of doing your business plan, your cash flow projections, and so forth, I think, is a weed out process for some of the smaller borrowers.

It also, I think, reduces your default rate and ultimate liquidations because those borrowers who do not have access to a 7(a) program or a structured business loan will go and finance their programs with credit card debt or home equities and vehicle loans and so forth. They do not really have the opportunity to really take a step back and, with the guidance of a seasoned loan professional, take a look at what their business prospects are.

I also think that SBA and the borrowing community would be well served with a more centralized process, not only for the PLP lenders but also for those lenders, particularly the credit unions, who are applying to become 7(a) lenders. Again, I understand where SBA is coming from on this, but it is difficult to have to deal with every district office and their varying requirements for becoming an SBA certified lender. I would love to see SBA work towards a more centralized role for both PLP and that.

Finally, I would just like to commend Mr. Bew and his staff, who have really been very helpful with us in helping to put our program together. I know exactly what you guys are up against, but we do appreciate all the efforts that you have had to date and we look forward to working with you in the future.

Chair SNOWE. Thank you very much.

Mr. MERSKI. Thank you, Madame Chair, Paul Merski with the Independent Community Bankers of America. We represent over 5,000 community-based banks around the Nation in all 50 states. A number of our community banks are the No. 1 SBA lenders in their state.

First of all, we would like to see at least a $12 to $13 billion program funding level. Based on our projections for the next 12 months, we are looking at $12 to $13 billion in SBA 7(a) loan volume demand. The $9.3 billion earmarked in the budget is very inadequate for the demand that our bankers are seeing for the loan program.

In surveying our community bankers on some of the problems they had with SBA loan programs last year, when the budget funding was in jeopardy and the SBA quickly put in a loan cap amount, decreasing to $500,000 the loan limit amount, we heard from a

number of our bankers that a number of their loans that were in process had fallen through. That is unfortunate because that was jobs that were not created and business that was not created. It was unfortunate that the SBA had so quickly put in that loan cap without fair warning to the bankers who were in the process of processing SBA loans over $500,000, and were unable to complete those loans.

So we are hoping that the budget funding would be adequate enough so that rationing of loans would not be put in place.

Also, the fee structure. The most sensitive thing for the community banker to do SBA lending is the fees that are associated with that. We would like to see the current fee structure, that was reduced a couple of years back now, kept in place. Any slight increase in fees, you are going to see a quick drop off in the amount of SBA lending that our bankers will do. It is a very marginally profitable activity for them now and if the fees go up even slightly, I think they will be dropping off their SBA business.

Another concern that our bankers have expressed and that we hope can be addressed is the fact that the SBA guarantee is often not a guarantee. We have had a number of our bankers complain that when a loan went bad for various reasons and they went to the SBA and said, "Well, we would like to see our guarantee in effect now", and the SBA came back and said, "It is not really appropriate that we give you the full guarantee or any of the guarantee."

That has, frankly, caused a large number of our community bankers to completely drop out of the program because they cannot take the risk with the low margins they make on these loans that the guarantee will not be there from the SBA.

They were also disappointed in the treatment that they received from the SBA on these debates over what the guarantee should be on particular loans.

Finally, we are also concerned with the quick action the SBA had taken on allowing the tax-exempt credit unions into the program. There was no proper administrative procedures action taken for a radical change in that program. We are somewhat concerned that the default rate on these loans might be impacted as the credit unions, who have little or no experience in commercial lending, and in fact are limited by the banking laws from expanding into commercial lending, enter these programs.

We would request that a separate database, or at least separate information, is kept on the default rate for credit union lending activities versus the participants in the program as of now.

Finally, one of the other complaints we have heard from our bankers when we surveyed them is what has been mentioned here several times already as the access to the Preferred Lender Program and the complications of being determined as a preferred lender. Many of our bankers have been in the lending business for over 100 years and still have a difficult time of convincing the SBA to get them up and running in the Preferred Lender Program. A lot of work needs to be done there to make that easier and quicker.

If you are not in the Preferred Lending Program, it is almost impossible to compete with other lenders who can offer a loan in 48 hours when it would take weeks for you to get your SBA loan if

you are not in the Preferred Lender Program. Those are some of the suggested changes we would like the Committee to look at.

Thank you.

Chair SNOWE. Thank you very much, Paul.

Mr. FELDMANN. Thank you, Senator.

I am Greg Feldmann. I am with Gryphon Capital Advisors based in Roanoke, Virginia. We are in the business of advising and helping small- and medium-sized businesses access capital, both equity and debt.

We just wanted to share our experience today over the last 6- or 8-year period. The problems that small businesses have, in terms of accessing capital through the banking system generally, and some of the constraints that we are seeing, as well as comment on—this would probably fall under the innovations or other recommendations category—to encourage the Committee to perhaps authorize the SBA to provide a limited form of credit enhancement, so that business loans could be securitized and create a capital markets solution for having capital flow into small businesses.

The 7(a) program is a good program. We think that there have been improvements made over time. What we are seeing structurally, within the banking community with consolidation, is we have fewer outlets for our type of businesses to go and seek capital. The community banks that we interface with, and we have polled over 60 of them in the western Virginia and North Carolina area principally, are actually fighting a funding problem. Attracting core deposits has become a problem and they are hitting against walls, in terms of being actually able to fund loans.

They are also obviously facing a lot of increased competition from larger banks, securities firms, et cetera. The deposit-to-loan ratio—and we have prepared a little piece for the record here—most of these banks are at 40-year highs.

[The information follows:]

Presentation to the U.S. Senate Committee on Small Business and Entrepreneurship

April 30, 2003

Executive Summary and Agenda

- We are pleased to have the opportunity today to discuss our views on the current environment and challenges facing the community banking industry, especially as it pertains to the small business lending environment. We will:
  - Describe the issues that constrain banks and other lenders (especially those located in smaller metropolitan or rural areas) from being able to originate and fund small business loans in their communities.
  - Describe the issues we have experienced on behalf of past corporate finance clients whose loan requirements fall between being too large for community banks and too small for the large banking institutions.
  - Describe, generally, the efficiencies and advantages of capital market-based funding of other asset classes like mortgages, credit cards, auto loans, etc.
  - Encourage the Committee to authorize the Small Business Administration to implement a limited form of credit enhancement supporting pooled loan securities to attract institutional investors as a funding source for small business loans.

Business borrowers are being impacted by industry consolidation.

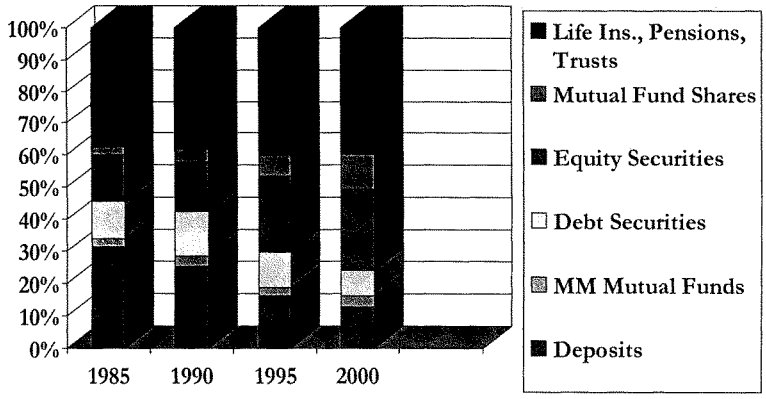
- The number of banking institutions in the U.S. have dropped from approximately 15,000 to 8,000+ over the past two decades.
- Many small business borrowers are often caught between large and small banks
  - Large banks tend to standardize credit products/underwriting practices and prefer larger borrowers
  - Large banks often channel community deposits to higher growth urban & suburban areas
- Banks are the primary source of external financing for small business borrowers
  - Borrowers tend to be very dependent on a local banker being able to understand the idiosyncrasies and local market conditions of the small business

Many banks have experienced funding pressures due to:

- Increased Competition
  - As in many other industries, the advent of deregulation and the use of technology/internet has helped spark an increase in the number of competitors vying for funding sources.
    - Large Banks (Wachovia, Bank of America, etc.)
    - Combination Brokerage Houses/Banks (E*Trade Bank, Schwab Online, etc.)
    - Online Loan Companies (Lending Tree, etc.)
    - Money Market Mutual Funds
    - Insurance companies

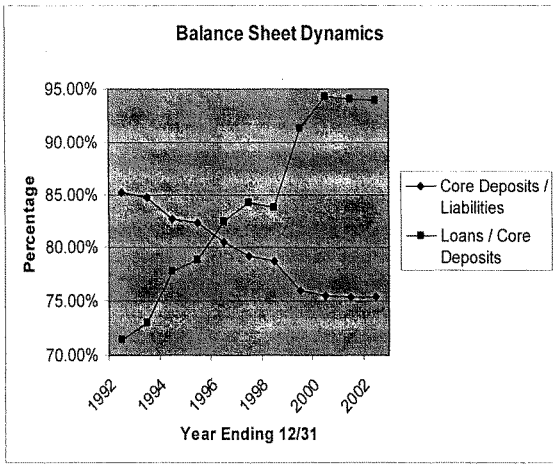
- Changing Demographics and Diminishing Deposits
  - Consumers are more technically sophisticated and more attuned to rates rather than relationship and history.
  - US is experiencing a rising middle age demographic (people between 35 and 65)
    - This segment constitutes 38.6% of U.S. population as of 2000 census vs. 36.1% in 1995
    - People in this age group have longer-term savings goals and and are more likely to seek higher returns with less liquid investments such as stocks, bonds and mutual funds
  - Core deposit funding as a percent of total liabilities in rural community banks dropped from ~90% in 1988 to ~80% in 2000 (urban community banks dropped from ~86% to ~82% in the same period)

Composition of U.S. Household Assets 1985-2000
(% share of total)



Source: Federal Reserve Data

Shrinking deposits from intense competition and a tight regulatory environment are putting pressure on Community Banks in filling the needs of small business borrowers.



Source: FDIC

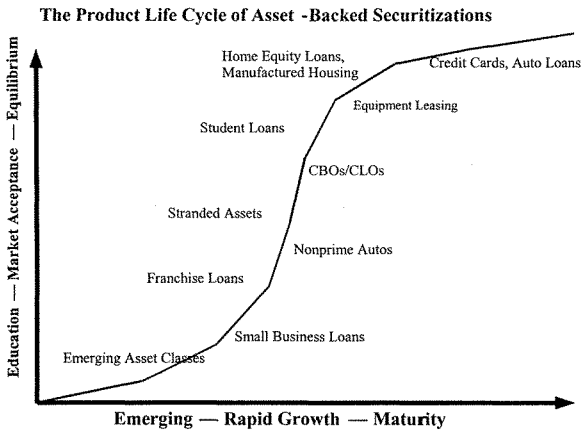
…Many hurdles need to be overcome before commercial loan securitization becomes commonplace…[but] it is by no means difficult to envision that a couple of decades from now, markets for business loan securities will be a reality…Only those bankers willing to embrace the technological change will share in the benefits.

Federal Reserve Board of Governors
Chairman Alan Greenspan
Speech before the American Bankers Association
October 1994

Advantages to both banks and borrowers…

- Many small business lending community banks are very familiar with the process of selling and participating out loans.
  - Have long been used by community bankers to free up their balance sheets, better control risk exposures, and meet the needs of major borrowers.
  - Gives community banks the ability to originate more loans while managing credit exposures to individual customers or industry segments.
  - Typically provided by the Bankers' banks, a system that provided a means for coordinating such transactions.
- Loan securitization will offer another opportunity for banks to adjust their balance sheets, although much of this activity for community banks has been confined to conventional real estate loans.
  - Would provide an alternative for the small business loans backed by commercial real estate and other assets in addition to the mortgages.
- Allow the community banker to make "good" loans to "good" customers
  - Many bankers would get full on a specific credit and be forced to turn away customers to bigger banks
  - Polling of 60+ community banks in the Virginia and North Carolina rural area shows an overwhelming response to participate in a government established program to provide a liquidity solution.

Investors in the asset-backed security arena believe that small business loans represent the next great asset class. In graphing the life cycle of small business loans compared to other asset classes, small business loans are at the base of a steep growth curve.



The chart below compares the "idealized" spread (the spread merited by the intrinsic risk as reflected by actual loan loss and prepayment experience) for various asset classes with the current spread assigned by the capital markets. A larger difference between actual and idealized spread indicates a higher than necessary cost of funding the asset class, resulting from an incorrect perception of credit risk.

Asset-Backed Securitization Spread Comparison

	Credit Cards	Autos	Equipment	Conventional Small Business Lending
AAA Spread to 3-Month LIBOR (bps)	**12**	**13**	**26**	**50**
AAA Idealized Spread to 3-Month LIBOR (bps)	**12**	**13**	**16**	**25**
Difference (bps)	**0**	**0**	**10**	**25**

Support for Pooled Small Business Loan Securities

- SBA should provide partial credit enhancement to back the sale of privately-issued debt securities backed by pools of qualifying small business loans originated by banks and other lenders.
- SBA credit enhancement could be structured in a "second loss" position
- SBA would be able to facilitate a higher volume of small business lending per dollar of credit enhancement
- Cost of credit enhancement would be fully supported by fee payments from pooler/managers (no subsidy cost to taxpayer)
- SBA could license and regulate a limited number of pooler/managers, similar to its SBIC program
- Pooler/managers would purchase eligible loans and issue the loan-backed securities at yields reflecting investment grade
- Proceeds from the sale of these securities would become available to lenders as a new source of funding for increased small business lending.

Presenting Team

- Gregory W. Feldmann
  - Has over 20 years in commercial banking, investment banking, and venture capital experience.
  - Loan production and management responsibilities that covered Virginia and contiguous states.
  - Has held management position at Gryphon Capital Partners, Dominion Investment Banking, Inc. and served as President of Dominion Capital Markets Corporation (an SBA licensed SBIC)
  - Has executed venture capital investments, advised companies and their owners on debt and equity placements, management buyouts, sell-side engagements, divestitures, and both leveraged and unleveraged ESOP transactions.
  - Hampden-Sydney College (Phi Beta Kappa, ODK and Baker Scholar) graduate, and a former W. K. Kellogg Foundation National Leadership Fellow.

- Scott A. Graeff
  - Has over 12 years in securitization, venture capital investing, investment banking, consulting, and start-up experience.
  - Has held management position at Gryphon Capital Partners, Dominion Capital, Inc. and Andersen Consulting. He was the founder and CFO of Liquidity Link, Inc, a wholly owned subsidiary of Reuters Corp.
  - Managing Director of Dominion Capital, a $7 billion boutique Investment Bank and Venture Capital Funds that are wholly owned by Dominion Resources (NYSE: D).
  - Grew the venture capital, private equity and mezzanine debt practice to $4.5 billion under management across several funds, with investments throughout the United States, Mexico, Russia and the United Kingdom.
  - As a senior consultant with Andersen, he analyzed, modeled and structured mortgage-backed and asset-backed securities. Securitized commercial real-estate transactions through a CMO structure.
  - B.S. in Finance from The University of Virginia, where he was an Echols Scholar.

Mr. FELDMANN. So it is not just a matter of having the dollars appropriated, but it is actually having the monies available in the banks, from a liquidity standpoint, to be able to fund the loans.

We think there is a role that the SBA could play in providing, as a complement to the 7(a) program, a limited form of guarantee to allow poolers and aggregators of small business loans to purchase those loans from the community banking system, sell those into the capital markets, and over a period of time have business loan category become much like the asset-backed categories of mortgages and automobile loans, et cetera, that are prevalent in today's market.

We wanted to simply come on record today and encourage, in this reauthorization process, that the Committee look at this as a means for the SBA to help facilitate funding for small business in a different sort of way than just the 7(a) program.

Chair SNOWE. Have you ever considered that, Ron?

Mr. BEW. Yes. I am from Virginia and people will think I put Greg up to this. I do not know Greg.

But that is what we mentioned in the budget about what we are calling pooling. We have explored it. We do not have anything definite, but the concept was obviously to provide more capital for small business outside of the 7(a) program. If the SBA could use its guarantee for a pool of loans, it would free up the banks to liquefy their assets and then reload, so to speak, and make more business loans.

So yes, we are looking at it because it would be good for small business.

Ms. FORBES. When you were looking at it, were you considering this in addition to fully finding the 7(a) program?

Mr. BEW. It would be additional, yes. Definitely additional, not to supplant or replace the 7(a).

Chair SNOWE. Doug.

Mr. CRISCITELLO. That is a good segue into my comments.

I am Doug Criscitello from J.P. Morgan Chase. We are the parent company of Colson Services Corp., which is the fiscal and transfer agent for SBA for loans that are sold on the secondary market.

I think it is important to point out the importance of the secondary market here. As Mr. Bew just referred, a secondary market allows a lender to take a loan that has been made, sell it, generate additional liquidity, and make additional loans. That cycle goes on and on. The existence of a very fluid secondary market is critical to that equation.

Go back in time 20 years to when there was no formal structure in place for a secondary market for 7(a) loans. It was a very inefficient and cumbersome process to get rid of loans that were on your books. The Congress stepped in in 1984 and passed the Secondary Market Improvement Act. SBA quickly implemented that Act, hired Colson Services Corp. to serve as the fiscal and transfer agent. Over time, the process has become more and more efficient. I would really point to it as a model public/private partnership in that it is important to know that we have a very active fluid secondary market and the cost to taxpayers over the last 17 years has been zero. It is a partnership that has worked extremely well.

I would like to commend the SBA for a fine job it has done over the years.

Chair SNOWE. We appreciate, as I am sure they do, your comments.

We want to move on to the Microloan Program. Next will be Tony, David, and Michael. You can make three quick comments and then we will move on to the Microloan Program. Then you can come back to anything else after I leave, however, I want to get your comments in.

Mr. WILKINSON. I just want to touch on a couple of items that Ron and some of the others have talked about.

We went through a period in the 1990s of a very good economy where lenders were making loans, we call it fringe loans, without an SBA guarantee.

History changed on 9/11. Lenders pulled in their credit horns. Borrowers who were on the fringe now found themselves being put into the 7(a) program. We think that the history that is relevant is what has happened since 9/11 and that we are going to continue to see the kinds of loan volume that we saw last year.

Yes, we did $9.3 billion, $9.4 billion in the 1990s, but this is a new day. We are going to continue to see the higher loan volumes and hope we can find a way to fund those loans.

Second, Mr. Bew made a comment that this was really a job creation program. There is nothing in the Small Business Act that says this is a job creation program. This is a long-term credit program for small business. There are businesses out there, in particular manufacturers, who use the 7(a) program to buy specialty equipment that makes them much more efficient, and is critical to their operations. It is not only job creation, it is really a long-term capital program for small business.

I wanted to echo the comment that Mr. Byrnes made about the Express Program. That really is one of the highlights of the Agency. They have found a new way to get the large banks back in the program by SBA Express, and they have really done a masterful job refining that program and getting it where it works.

The one issue we have is that it appeared, going through the last fiscal year, that they were trying to use the Express Program to replace the existing 7(a) program. That is where we would be at great odds, doing only Express loans at the expense of putting other loans aside.

We fully support keeping the fees the same. If you go back a few years, and it is part of the subsidy issue that we touched on just briefly. The fees that were required to be charged to borrowers and lenders were excessive. It was done through the subsidy calculation, and well over $1 billion has been sent to Treasury, taken out of the pockets of borrowers and lenders, that could have been used in their business operations or for other loan incentives.

Some lenders finally figured out what was happening to them, and that they really were not making a profit in this program and they left the program, including a lender who was the largest volume lender in the country, and got out of the program.

At that point in time, we started working with Senator Bond and Senator Kerry saying fees have got to come down. If they do not fix the subsidy rate, that is one issue. We have got to get the fees

down so we will keep lenders in the program to deliver it. The fees came down, lenders are coming back to the program.

So it will be very important that we keep those fees and do not allow that change to sunset. Thank you.

Chair SNOWE. Tony, in talking about the explosive growth in the 7(a) loans, and what you are recommending, do you see that as a trend or an aberration? In this last year, because you took a 3-year average; is that correct?

Mr. WILKINSON. He used a 3-year average in his daily loan volume. What we are seeing is a spike post-9/11.

Chair SNOWE. Do you see that as a trend? Do you think that is sustainable?

Mr. WILKINSON. I think that the days of $9 billion in 7(a) lending are over. We are going to see higher levels, especially if—again, you look at the volume in the Express Program, the big banks are finding that a great program, they are coming on board. The loan cap is now gone.

We would have had higher volume in the first 6 months of this fiscal year were there not a $500,000 loan cap. Where the next cycle is, where the times are good and the lenders are making more loans absent the guarantee, I do not know when that period is.

However, in the near future, we are going to see higher loan volumes.

Chair SNOWE. Thank you. I would like to call on Davi D'Agostino from GAO.

Ms. D'AGOSTINO. Thank you. I am very pleased to be here this morning to discuss GAO's work on SBA's 7(a) preferred lender oversight.

Why is it so important for SBA to have a credible preferred lender oversight program? First of all, preferred lenders approved nearly $7 billion in Government guaranteed 7(a) loans in fiscal year 2002 alone with full approval authorities delegated by SBA. This amounts to significant exposure for the taxpayer.

The preferred lenders that are banks are overseen by bank regulators whose main focus is not on the quality of Government guaranteed 7(a) loans or their appropriateness for the 7(a) program mission goals.

The other preferred lenders, the SBLCs who we have heard from today, are not otherwise regulated or examined. The SBA did contract with Farm Credit Administration to examine the SBLCs in response to our 1998 recommendation.

Strong oversight is needed to maintain the integrity of the 7(a) program in meeting its mission to provide credit to those who cannot get it elsewhere.

What do we find in our work? SBA certainly has made a tremendous amount of progress since our 1998 report when there was virtually no lender oversight. Still, we identified several aspects of the program that do need some improvement.

The program does not adequately focus on the 7(a) portfolio risk at both bank lenders and the SBLCs. For example, it was optional to evaluate financial risk in preferred lender oversight reviews at the time of our work.

Preferred lender reviews have also been cursory checklist file reviews and do not qualitatively evaluate or test lender decisions on

eligibility, for example, how they use the credit elsewhere test and apply it, and the credit worthiness.

Also, SBA standards for the credit elsewhere test are very broad and variable, making it difficult to assess lender decisions about eligibility as they are currently written.

The SBA has also been slow to respond to important Farm Credit Administration recommendations in their examinations about the program and even specific SBLCs.

For example, Farm Credit has recommended that the SBA better define for SBLCs what constitutes a delinquent loan, and also what constitutes adequate capital for capital requirements purposes. That is how much capital an SBLC should hold against the risk on its books. This would obviously greatly affect the amount of taxpayer exposure to higher SBA 7(a) costs in the long run.

SBA also had not developed enforcement policies and procedures to No. 1, deal with the safety and soundness problems at SBLCs and in bank lenders' 7(a) portfolios; or to No. 2, describe the grounds for suspending or revoking preferred lender status.

Finally, we found that the SBA's Office of Lender Oversight is within the Office of Capital Access, which is a program promotion function, which also recruits lenders to participate in the 7(a) program. This raises potential conflicts of interest and independence concerns when you are doing oversight and evaluation. They should be separated. The promotion and oversight should be separated.

What did we recommend and what was SBA's position? We recommended improvements to the preferred lender oversight program in all of the areas I mentioned, including the need to separate lender oversight functions and responsibilities from the Office of Capital Access. It is not clear in all cases that the SBA fully responded to all of our recommendations, but the SBA seemed to agree with part or all of the recommendations to improve its assessments of the lenders and to separate lender oversight from OCA. But the SBA said it was working to expand its enforcement policies and procedures.

I also wanted to mention we have related ongoing work, looking at the new 7(a) credit subsidy model that the Administration and the SBA came up with at the request of Senator Kerry and the House Committee on Small Business.

We are also looking at SBA's transformation initiatives.

[The prepared statement of Ms. D'Agostino follows:]

United States General Accounting Office

GAO

Testimony
Before the Committee on Small Business and Entrepreneurship, U.S. Senate

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SMALL BUSINESS ADMINISTRATION

Progress Made but Improvements Needed in Lender Oversight

Statement of Davi M. D'Agostino
Director, Financial Markets and Community Investments

GAO-03-720T

Madam Chair and Members of the Committee:

I am pleased to be here today at this roundtable to discuss the results of our work on the Small Business Administration's (SBA) oversight of its 7(a) loan program lenders, particularly those who participate in the Preferred Lenders Program or PLP. SBA delegates full authority to preferred lenders to make loans without prior SBA approval. In fiscal year 2002, preferred lenders approved 55 percent of the dollar value of all 7(a) loans—about $7 billion. Small businesses are certainly a vital part of the nation's economy. According to SBA, they generate more than half of the nation's gross domestic product and are the principal source of new jobs in the U.S. economy. In turn, SBA's mission is to maintain and strengthen the nation's economy by aiding, counseling, assisting, and protecting the interests of small businesses. Providing small businesses with access to credit is a major avenue through which SBA strives to fulfill its mission. Strong oversight of lenders by SBA is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. SBA has a total portfolio of about $46 billion, including $42 billion in direct and guaranteed small business loans and other guarantees.[1] Because SBA guarantees up to 85 percent of the 7(a) loans made by its lending partners, there is risk to SBA if the loans are not repaid. SBA must ensure that lenders provide loans to borrowers who are eligible and creditworthy to protect the integrity of the 7(a) program.

Our statement today is based on the report we issued December 9, 2002, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight* (GAO-03-90). The report and our remarks will focus on our evaluation of (1) SBA's 7(a) lender oversight program and (2) SBA's organizational alignment for conducting oversight of preferred lenders and Small Business Lending Companies (SBLC).[2] In addition, we will comment on SBA's latest response to our findings and recommendations.[3] Our overall objective is to provide the Committee with information and perspectives to consider as it moves forward on SBA reauthorization.

[1]As of September 30, 2002.

[2]SBLCs, which make only 7(a) loans, are privately owned and managed, nondepository, lending institutions that are licensed and regulated by SBA but not generally regulated or examined by financial institution regulators.

[3]Hector Barreto, SBA Administrator, letter to The Honorable Susan Collins, Chair, Committee on Government Affairs, U.S. Senate, March 12, 2003.

In analyzing SBA's oversight of its preferred lenders, we defined oversight to include both SBA's reviews of preferred lenders for compliance with SBA rules and regulations and SBA's evaluations of lenders to decide their initial and continued participation in the PLP. We focused our reviews in part to follow up on recommendations made in our June 1998 report, where we found that SBA was doing few reviews of its preferred lenders.[4] We analyzed a sample of review reports and PLP guidance, and review and lending data to the extent that they were available. We also interviewed SBA headquarters and regional staff, PLP lenders, and representatives of the National Association of Government Guaranteed Lenders.

Summary

SBA has made progress in developing its lender oversight program, but there are still areas in need of improvement. While SBA has identified appropriate elements for an effective lender oversight program, it has been slow to change programs and procedures to fully incorporate all of these elements. In addition, financial risk management issues have become more critical for SBA, as its current loan programs focus on partnering with lenders, primarily banks, that make loans guaranteed up to 85 percent by SBA. However, our work showed that

- SBA had not yet consistently incorporated adequate measures of financial risk into the PLP review process or the SBLC examination program.
- The current PLP review process, which SBA uses to ensure compliance with the program mission, rules, and regulations, involves a cursory review of documentation maintained in lenders' loan files rather than a qualitative assessment of borrower creditworthiness or eligibility.
- SBA's standards for borrower eligibility (the "credit elsewhere" requirement) are broad and therefore subject to interpretation.
- SBA had not developed clear enforcement policies for preferred lenders or SBLCs that would specifically describe its response in the event that reviews discover noncompliance or safety and soundness problems.

[4]U.S. General Accounting Office, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO/GGD-98-85 (Washington, D.C.: June 1998).

- SBA had been slow to finalize and issue SBLC examination reports.[5] In addition, SBA had been slow to respond to recommendations for improving the SBLC examination program.

Without continued improvement to better enable SBA to assess the financial risk posed by 7(a) loans and to ensure that its lending partners are making loans to eligible small businesses, SBA will not have a successful lender oversight program.

Although SBA has listed the oversight of its lending partners as an agency priority, the function does not have the necessary organizational independence or resources to accomplish its goals. In our past work analyzing organizational alignment and workload issues, we have described the importance of (1) tying organizational alignment to a clear and comprehensive mission statement and strategic plan and (2) providing adequate resources to accomplish the mission. However, two different offices—Lender Oversight and Financial Assistance, both of which are in the Office of Capital Access (OCA)—carry out SBA's lender oversight functions (see fig. 1). OCA also promotes and implements SBA's lending programs. This alignment presents a possible conflict because PLP promotion and operations are housed in the same office that assesses lender compliance with SBA safety and soundness and mission requirements. Additionally, split responsibilities within OCA and limited resources have impeded SBA's ability to complete certain oversight responsibilities, which could result in heightened risk to its portfolio or lack of comprehensive awareness of portfolio risk.

Our report made recommendations to improve SBA's oversight of its lenders. Specifically, we recommended that SBA:

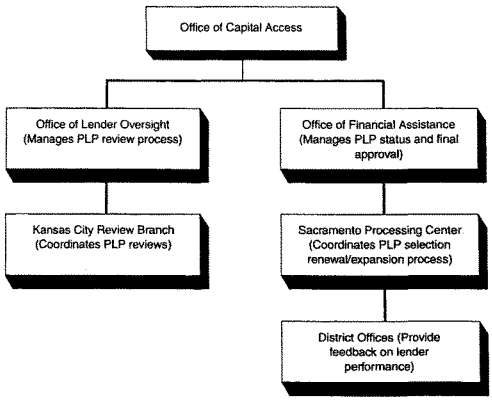
- incorporate strategies into its review process to adequately measure the financial risk lenders' portfolios of guaranteed SBA loans pose to SBA,
- develop specific criteria to apply to the credit elsewhere standard used to determine borrower eligibility,

[5]Since 1999, SBA has had an agreement with the Farm Credit Administration (FCA) to conduct safety and soundness examinations of the SBLCs. FCA is an independent agency within the executive branch; it regulates Farm Credit System institutions. FCA also contracts with other government agencies to provide examination services.

- perform qualitative assessments of lenders' performance and lending decisions,
- clarify its enforcement authority and specify conditions under which it would take enforcement action,
- make the preferred lender program more accessible to large national lenders, and
- better emphasize lender oversight in its organizational alignment to provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight.

SBA essentially disagreed with part or all of our recommendations for improving its assessments of lenders, said that it was "working to address" issues we raised about enforcement and accessibility of the preferred lender program, and disagreed with our recommendation to separate lender oversight functions and responsibilities from preferred lender program management functions.

Figure 1: Preferred Lender Oversight Responsibilities within OCA



Source: GAO analysis of SBA's structure.

Background

The 7(a) loan program, which is authorized by Section 7(a) of the Small Business Act, is SBA's largest business loan program.[6] It is intended to serve small business borrowers who otherwise cannot obtain financing under reasonable terms and conditions from the private sector. In administering the 7(a) program, SBA has evolved from making guaranteed loans directly to depending on lending partners, primarily banks.[7] Under 7(a), SBA provides guarantees of up to 85 percent on loans made by participating lenders.

Within 7(a), there are three classifications of lenders—regular, certified, and preferred. SBA evaluates and grants preferred lender status to 7(a)

[6]15 U.S.C. § 636 (2000).

[7]Other types of financial institutions, such as savings banks, are lending partners. In this statement, we refer to all financial institutions that make 7(a) loans as banks.

lenders after receiving nominations and reviews from its 70 district offices and a regional processing center. Of the three categories, preferred lenders have the most autonomy in that they can make loans without prior SBA review or approval. Most preferred lenders are banks that have their own safety and soundness regulators, such as the Office of the Comptroller of the Currency. Those regulators, however, may not focus on the 7(a) loans that SBA guarantees when they examine the bank. The other preferred lenders, which are SBLCs, have no regulator other than SBA—making SBA oversight more critical. As of August 2002, SBA had over 400 preferred lenders. To give you an idea of this program's scope, in fiscal year 2002, 7(a) loan approvals totaled approximately $12.2 billion, of which preferred lenders approved $6.7 billion. However, preferred lending activity is concentrated in a few larger institutions. Less than 1 percent of 7(a) lenders account for more than 50 percent of 7(a) dollar volume outstanding. According to SBA, most of these lenders are preferred lenders.

Two offices within SBA have primary responsibility for 7(a) lender oversight—the Office of Lender Oversight (OLO) and the Office of Financial Assistance (OFA). OLO is responsible for many oversight functions, such as managing all headquarters and field office activities regarding lender reviews. However, OFA has retained some oversight responsibilities. OFA's current role in lender oversight is to provide final approval of lenders' PLP status. Lenders are granted PLP status in specific SBA districts for a period of 2 years or less. OFA collects information about the lender prepared by the Sacramento Processing Center, with input from one or more of SBA's 70 district offices, and decides whether to renew a lender's PLP status or to grant status in an additional district. OFA may also discontinue a lender's PLP status.

Other lenders participating in the 7(a) program are subject to a different oversight regime. Specifically, SBA divides SBLC program functions between OLO and OFA. OLO is responsible for SBLC on-site examination, and OFA handles day-to-day program management and policymaking. Ultimate responsibility for enforcement of corrective actions rests with OCA. As participants in the 7(a) program, SBLCs are subject to the same review requirements as other 7(a) lenders, and they are also subject to safety and soundness oversight by SBA.

Lender Oversight Is Not Achieving All of Its Goals

SBA has identified goals for its lender oversight program that are consistent with appropriate standards for an oversight program; however, SBA had not yet established a program that is likely to achieve them. Since our last review, SBA had made progress in developing its lender oversight program, but there are still areas in need of improvement if SBA is to develop a successful program. SBA has highlighted risk management in its strategy to modernize the agency; however, PLP reviews are not designed to evaluate financial risk, and the agency has been slow to respond to recommendations made for improving its monitoring and management of financial risk—posing a potential risk to SBA's portfolio. PLP reviews are designed to determine lender compliance with SBA regulations and guidelines, but they do not provide adequate assurance that lenders are sufficiently assessing eligibility and creditworthiness of borrowers.

Although SBA has identified problems with preferred lender and SBLC lending practices, it has not developed clear policies that would describe enforcement responses to specific conditions. Thus, it is not clear what actions SBA would take to ensure that preferred lenders or SBLCs address lending program weaknesses. Although the process for certifying lenders for PLP status—another means by which SBA oversees lenders—has become better defined and more objective, some lenders told us they continue to experience confusing and inconsistent procedures during this process due to varying recommendations from field offices.

SBA Has Made Progress in Developing Its Lender Oversight Function

Since our June 1998 report, SBA has responded to a number of recommendations for improving lender oversight by developing guidance, establishing OLO, and doing more reviews. SBA developed "Standard Operating Procedures" (SOP) for oversight of SBA's lending partners and the "Loan Policy and Program Oversight Guide for Lender Reviews" in October 1999.

SBA established OLO in fiscal year 1999 to coordinate and centralize lender review processes for PLP and SBLC oversight. OLO created a "Reviewer Guide" for personnel engaged in PLP reviews and does training for all SBA staff involved in conducting preferred lender reviews. OLO officials said that to effectively oversee and monitor SBA lenders, they also evaluate lender-generated risk to the SBA portfolio, work with SBA program offices to manage PLP oversight operations, and plan to conduct regular and systematic portfolio analysis using a new loan monitoring system. Additionally, to minimize the number of visits SBLCs receive during a year, OLO combined PLP reviews with SBLC examinations performed by FCA.

In another effort to improve the lender review process, SBA developed an automated, 105-item checklist that is designed to make its analysis more objective. The questionnaire addresses lender organizational structure, policies, and controls, but the answers are provided in a "yes-no" format and generally refer to the presence or absence of specific documents. SBA noted that the format makes assessments of lenders more consistent and objective. However, we note that without a more substantive method of evaluating lender performance, this approach does not provide a meaningful assessment.

SBA also has increased the number of PLP reviews performed. In June 1998, we reported that SBA had not reviewed 96 percent of 7(a) lenders, including preferred lenders, in the districts we visited. SBA reviewed 385 reviews of 449 preferred lenders in its 2001– 2002 review year.[8]

SBA's Lender Oversight Does Not Adequately Focus on Financial Risk

While elements of SBA's oversight program touch on the financial risk posed by preferred lenders, including SBLCs, weaknesses in the program limit SBA's ability to focus on, and respond to, current and future financial risk to their portfolio. Neither the PLP review process nor SBA's off-site monitoring efforts adequately focus on the financial risk posed by preferred and other lenders to SBA. SBA oversight of SBLCs is charged with monitoring how SBLCs administer their credit programs, identifying potential problems, and keeping SBA losses to an acceptable level. However, SBA's progress in reporting examination results in a timely manner and implementing other program improvements limits the effectiveness of SBA's SBLC oversight.

SBA officials stated that PLP reviews are strict compliance reviews that are not designed to measure the lenders' financial risk. Our review and that of SBA's Inspector General (IG) confirmed this. The PLP review serves as SBA's primary internal control mechanism to determine whether preferred lenders are processing, servicing, and liquidating loans according to SBA standards and whether such lenders should participate in the programs. While the review has questions that touch on the financial risk of a given loan, review staff are not required to answer them; and SBA guidance explicitly states that the answers to the questions are for

[8]SBA's review year runs from April 1 to March 31. SBA officials explained that the initial date of its contract with the vendor that conducts PLP reviews began on April 1, and they have since used this as the beginning of their review year.

research purposes only and are not to be considered in making any determinations about the lender. By not including an assessment of the financial risk posed by individual lenders during PLP reviews, SBA is missing an opportunity to gather information that could help predict PLP lenders' future performance, thereby better preparing SBA to manage the risk to its portfolio. The SBA IG also suggested that financial risk and lender-based risk should be considered as part of a comprehensive oversight program.[9]

SBA's off-site monitoring efforts do not adequately assess the financial risk posed by PLP and other lenders. SBA currently uses loan performance benchmarking and portfolio analysis to serve as its primary tools for off-site monitoring. While SBA officials stated that loan performance benchmarks are based on financial risk and serve as a measure to address a lender's potential risk to the SBA portfolio, we found that the benchmarks were not consistently used for this purpose.[10] In addition, we found that OLO does not perform routine analysis of SBA's portfolio to assess financial risk. At the time of our review, staff produced ad-hoc reports to analyze aggregate lending data to look for trends and to try to anticipate risk.

SBA Has Not Eliminated Weaknesses in SBLC Oversight That Pose a Threat to the SBA Portfolio

Currently, FCA staff responsible for SBLC safety and soundness examinations also perform PLP reviews at SBLCs—these reviews are the same ones that SBA contractors perform at preferred lenders and employ the same review checklist.[11] Upon the completion of its examinations, FCA provides a draft report to SBA for comment, incorporates any changes, and then provides a final report to SBA, which, in turn, issues a final report to the SBLC.

[9]The SBA Inspector General defines financial risk as the composite risk posed by loans and guarantees actually booked to SBA's portfolio and how they perform over time, and defines lender-based risk as the potential financial injury due to the lender's failure to perform its role properly. U.S. Small Business Administration, Office of Inspector General, *Audit Report PLP Oversight Process*, Report Number 1-19, (Washington, D.C.: September 27, 2001).

[10]The five benchmarks are ratios for currency, delinquency, default, liquidation, and loss. Each is defined in SBA's SOP.

[11]FCA conducts broad-based examinations and evaluates each SBLC's capital adequacy, asset quality, management, earnings, and liquidity. The examinations are similar to safety and soundness examinations performed by bank and government-sponsored enterprise regulators.

SBA has not eliminated weaknesses in SBLC oversight, which were cited by us and the SBA IG. We, and the SBA IG, found that final SBLC examination reports were not issued in a timely manner. SBA's IG reported that final reports for fiscal year 2001 SBLC examinations were not issued until February 2002, 10 months after OLO received the first draft report from FCA.[12] Our work confirmed these findings. We found that OLO does not maintain standards for the timely issuance of examination reports. However, OLO has recently developed draft customer service goals calling for SBLC examination reports to be finalized within 90 days of receipt of a draft report from FCA. However, as of August 2002, none of the examination reports from fiscal year 2002 had been issued. According to the IG, because of the delays in finalizing the reports and SBA's policy to delay any necessary enforcement actions until final reports are issued, two SBLCs were allowed to continue operating in an unsafe and unsound manner, despite early identification of material weaknesses during fiscal year 2001 examinations. The effectiveness of any examination program is measured, to a large degree, on its ability to identify and promptly remedy unsafe and unsound conditions. By delaying reporting and remedial action SBA has significantly limited the effectiveness of its SBLC oversight program.

SBA has been slow to implement recommendations from FCA for improving the SBLC examination program. In addition to examining SBLCs, FCA was asked by SBA to provide recommendations for changes in the SBLC program. Each year FCA provides its views in a comprehensive report. FCA's September 1999 report made 15 recommendations, 12 of which SBA agreed to implement.[13] We reviewed the reports for fiscal years 2000 and 2001, in which FCA made additional recommendations with which SBA agreed. Yet, the 2001 report still lists 8 recommendations from the 1999 report and 2 from the 2000 report. SBA officials explained that limited resources have contributed to the delay in implementation of many of these recommendations.

[12]U.S. Small Business Administration, Office of Inspector General, *Improvements Are Needed in the Small Business Lending Company Oversight Process*, Report No. 2-12 (Washington, D.C.: March 20, 2002).

[13]We listed the 15 recommendations in our November 2000 report. See U.S. General Accounting office, *Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight*, GAO-01-192 (Washington, D.C.: November 2000).

PLP Reviews Do Not Provide Adequate Assurance That Lenders Are Sufficiently Assessing Eligibility and Creditworthiness

Assessing whether a borrower is eligible for 7(a) assistance is difficult because the requirements are broad and variable, making a qualitative assessment of a lender's decision by a trained reviewer all the more important. SBA regulations require a lender to attest to the borrower's demonstrated need for credit by determining that the desired credit is unavailable to the borrower on reasonable terms and conditions from nonfederal sources without SBA assistance.[14] These "credit elsewhere" provisions are particularly difficult to assess and must be determined prior to assessing other credit factors.[15] SBA guidance also requires preferred lenders to certify that credit is not otherwise available and to retain the explanation in the borrower file.[16] SBA does provide guidance on factors that may contribute to a borrower being unable to receive credit elsewhere. Factors that lenders should consider include the following:

- The business requires a loan with a longer maturity than the lender's policy permits;
- The requested loan exceeds either the lender's legal limit or policy limit, regarding amounts loaned to one customer;
- The lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market;
- The collateral does not meet the lender's policy requirements because of its uniqueness or low value;
- The lender's policy normally does not allow loans to new ventures or businesses in the applicant's industry; and
- Any other factors relating to the credit that in the lender's opinion cannot be overcome except by receiving a guaranty.

Based on these criteria, the credit elsewhere test could always be satisfied by structuring an SBA guaranteed loan so that its terms and conditions differ from those available on the commercial market. As a result, these

[14]The SBA regulations do not further define "reasonable terms and conditions." See also 13 C.F.R. Section 120.101.

[15]Section 7(a) of the Small Business Act states that "no financial assistance shall be extended if the applicant can obtain credit elsewhere." 15 U.S.C. Section 636(a).

[16]SBA SOP 50-10(4)(E).

loans could be made available to businesses that could obtain credit elsewhere on reasonable market terms and conditions, although not the same terms and conditions offered with the SBA guarantee.

SBA officials stated that the credit elsewhere requirements are designed to be broad so as to not limit a lender's discretion and allow flexibility, depending upon geographic region, economic conditions, and type of business. For example, SBA officials said that when credit is more readily available, businesses that require SBA assistance might be held to a different standard, thereby making it more difficult to obtain the SBA guarantee than when credit is tighter. Nonetheless, the flexibility that lenders have along with the difficulty in assessing lenders' credit elsewhere decisions further support the need for developing specific criteria for a credit elsewhere standard. These changes would facilitate a more qualitative assessment of eligibility decisions made by preferred lenders.

Moreover, because it is a cursory review of documents in the file, the PLP review also does not qualitatively assess a lender's credit decision. Preferred lenders are required to perform a thorough and complete credit analysis of the borrower and establish repayment terms on the loan in the form of a credit memorandum. SBA guidance requires, at a minimum, discussion in the credit memorandum of a borrower's capitalization or proof that the borrower will have adequate capital for operations and repayment, as well as capable management ability.[17] SBA officials said that lender review staff focus on the lender's process for making credit decisions rather than the lender's decision. SBA officials said that it is unlikely that the review would result in a determination that the loan should not have been made. An SBA official stated that review staff would not perform an in-depth financial analysis to assess the lender's credit decision and that a lender's process would only be questioned in the case of missing documentation. For example, review staff would cite a lender if it did not document the borrower's repayment ability.

Some lenders we interviewed criticized the lack of technical expertise of contract review staff. The lenders stated that review staff was unable to provide additional insight into material compliance issues during the review because of a lack of technical knowledge of the underwriting process and requirements. For example, one lender said he was cited for

[17]SBA SOP 50-10(4).

not signing a credit elsewhere statement, but the reviewer did not evaluate a financial statement in the file substantiating the credit elsewhere assessment.

To improve PLP and SBLC oversight, we recommended that SBA incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the credit elsewhere standard, and perform qualitative assessments of lender performance and lending decisions. SBA stated that it believes the existing statutes, regulations, policies, and procedures provide sufficient guidance to lenders. These are the same sources we analyzed and found to be broad, making a qualitative assessment of a lender's decisions difficult. SBA has responded that it does measure financial risk of SBLCs through the safety and soundness examinations conducted by FCA and that the PLP lender reviews do estimate some degree of financial risk. We had noted both of these measures in our December 9, 2002 report. We also noted that SBA had not acted on suggestions that FCA had made to enhance SBA's oversight of SBLCs. Only 3 of 15 preferred lender review reports that we reviewed provided any evidence of such an assessment. And, we note, SBA's review guidance does not require such a review. Thus, our recommendations remain open.

SBA Has Not Developed Clear Enforcement Policies for Preferred Lenders and SBLCs

SBA has authority to suspend or revoke a lender's PLP status for reasons that include unacceptable loan performance; failure to make enough loans under SBA's expedited procedures; and violations of statutes, regulations, or SBA policies.[18] However, SBA has not developed policies and procedures that describe circumstances under which it will suspend or revoke PLP authority or how it will do so. SBA guidance does not include specific follow-up procedures for PLP lenders that receive poor review ratings, but it does discuss recommended patterns of follow-up. SBA officials said that, in practice, they request action plans to address deficiencies for any ratings of "minimally in compliance" and "not in compliance." In addition, lenders with ratings of not in compliance are to receive follow-up reviews. SBA officials explained that because they want to encourage lenders to participate in PLP, they prefer to work out problems with lenders, and therefore rarely terminate PLP status. And, where a lender persists in noncompliance, SBA will generally allow the status to expire, rather than terminating it. However, without clear

[18] 13 C.F.R. § 120.455 (2002).

enforcement policies, PLP lenders cannot be certain of the consequences of certain ratings and they may not take the oversight program seriously.

In November 2000, we recommended that the SBLC examination program could be strengthened by clarifying SBA's regulatory and enforcement authority regarding SBLCs. Although it has the authority to do so, SBA has yet to develop, through regulation, clear policies and procedures for taking supervisory actions. By not expanding the range of its enforcement actions—which it can do by promulgating regulations—SBA is limited in the actions it can take to remedy unsafe and unsound conditions in SBLCs. SBA regulations only provide for revocation or suspension of an SBLC license for a violation of law, regulation, or any agreement with SBA. Without less drastic measures, SBA has a limited capability to respond to unsatisfactory conditions in an SBLC. Unlike SBA, federal bank and thrift regulators use an array of statutorily defined supervisory actions, short of suspension or revocation of a financial institution's charter or federal deposit insurance, if an institution fails to comply with regulations or is unsafe or unsound.

We recommended that SBA provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders and SBLCs in the event of continued noncompliance with SBA's regulations. Most recently, SBA has responded that it does have clear policies and procedures; however, the agency intends to expand upon them. We will continue to followup and monitor SBA's response to this recommendation.

SBA's Process for Administering PLP Status Presents Lenders with Challenges

SBA's preferred lender certification process begins when a district office serving the area in which a lender's office is located nominates the lender for preferred status or when a lender requests a field office to consider it for PLP status. The district will then request performance data regarding the lender from SBA's Sacramento Processing Center. The processing center then provides the district office with data required to fill in part of a worksheet developed for the nomination process. The district office sends the completed worksheet, along with other required information, back to the processing center. The processing center analyzes the nomination and sends it with a recommendation to OFA for final decision.

According to SBA's SOP, in making its decision, OFA considers whether the lender (1) has the required ability to process, close, service, and liquidate loans; (2) has the ability to develop and analyze complete loan packages; and (3) has a satisfactory performance history with SBA. OFA also considers whether the lender shows a substantial commitment to

SBA's "quality lending goals," has the ability to meet the goals, and demonstrates a "spirit of cooperation" with SBA.

OFA and district office staff said that although district offices do not provide final approval of PLP status for lenders in their districts, they generally play an important role and district input is given significant weight. Most of the district office staff we interviewed believed that they had considerable influence on OFA's decision regarding a lender's PLP status.

A PLP lender may request an expansion of the territory in which it can process PLP loans by submitting a request to the Sacramento Processing Center. The processing center will obtain the recommendation of each district office in the area into which the PLP lender would like to expand its PLP operations. The processing center will forward the district recommendations to OFA for a final decision.

Lenders we interviewed had varying experiences in gaining and maintaining their PLP status. While some lenders expressed general satisfaction with the process and their understanding of it, others cited problems. For example, several PLP lenders we interviewed said that they had their PLP status declined in a specific district, although they had already achieved PLP status in other districts. In some instances, lenders said that they did not understand why they had been turned down, in light of their proven performance. These lenders commented that some district offices were not open to working with lenders from outside their districts while others were. In our interviews with district offices, we sometimes heard differing descriptions from district office officials on the level of commitment required of a lender who wished to gain PLP status in their district. Some district officials said that a lender had to maintain a physical presence in the district, while others disagreed. However, all district office officials expressed the need for some regular discussion with a lender to understand the lender's commitment to the district.

Larger lenders, as well as the National Association of Government Guaranteed Lenders (NAGGL), noted the administrative burden of maintaining relationships with many of the 70 district offices to maintain PLP status. The lenders noted that to receive and maintain PLP status in a given district, it is generally necessary to meet at least annually with district office staff to discuss status and plans for future lending. For some large national lenders, this can amount to 40 or more visits per year. In response to this concern, NAGGL has recommended a national PLP status based on a uniform national standard to ease the administrative burdens

on large national lenders that account for the largest volume of PLP lending.

District office officials that we interviewed generally acknowledged that they want to understand a lender's plans for their district before agreeing to endorse a lender that wishes to gain PLP status in their district. District officials explained that PLP status is an important marketing tool for lenders. As advocates for the credit needs of small businesses in their districts, the district office officials see PLP status as a "carrot" to encourage lenders to make a sufficient volume of loans to their district. They suggest that a "national" PLP lender might make a large volume of PLP loans nationwide, but none in their district. The officials reason that without a district-by-district PLP status, district offices would lose an important tool for encouraging lenders to respond to credit needs in their districts.

To hold lenders to a uniform national standard while maintaining individual district office's preferences and reinforcing their relationships with PLP lenders, SBA developed a formula-driven lender evaluation worksheet to facilitate the nomination, expansion, and renewal processes. The worksheet replaces the former procedure that involved written recommendations from district officials; however, it continues to award points based on sometimes subjective criteria, such as the district office's assessment of the lender's SBA marketing and outreach efforts, rather than the formulas in the spreadsheet. Where this is the case, district office staff are required to provide written justification for the points awarded.

SBA has a Lender Liaison program, managed by its Office of Field Operations (OFO), to assist large national lenders in managing relationships with SBA. The program involves the assignment of a single SBA official, generally a district director, to act as a liaison to a large national lender. In the event that a large lender should experience difficulty in managing its PLP status, it would have a single SBA official to call to assist in resolving any problems. OFO staff said that feedback they have received from lenders indicated that they like the program, finding it useful for resolving difficulties. Two of the lenders we interviewed participated in the program, and both expressed satisfaction with it. SBA has designated lender liaisons for 20 PLP lenders and, at the time of our review, intended to expand the program to 50 additional lenders. OLO identified 70 lenders who have PLP status in 6 or more districts and could benefit from the program.

We recommended that SBA continue to explore ways to assist large national lenders to participate in the PLP. SBA has indicated that they are reviewing the issues we identified with regard to large national lenders and considering the best approach to address the issues. We will continue to followup with SBA and monitor its response on this matter.

SBA's Organizational Alignment Does Not Adequately Support SBA's Lender Oversight Functions

In our past work analyzing organizational alignment and workload issues at SBA and other agencies' efforts to improve management and performance, we have described the importance of tying organizational alignment to a clear and comprehensive mission statement and strategic plan. By organizational alignment, we mean the integration of organizational components, activities, core processes, and resources to support efficient and effective achievement of outcomes. For example, we noted how agency operations can be hampered by unclear linkage between an agency's mission and structure, but greatly enhanced when they are tied together.[19] We have identified human capital management challenges in key areas, which include undertaking strategic human capital planning and developing staffs whose size, skills, and deployment meet agency needs.[20] We have also noted the importance of separating safety and soundness regulation and mission evaluation from the function of mission promotion. While SBA's role regarding PLP lenders is slightly different from that of a safety and soundness regulator, two principles still apply to SBA. First, oversight and program evaluation functions should be organizationally separate and maintain an arm's-length relationship from program promotion. And second, in evaluating program compliance, SBA needs to weigh the financial risks to the federal government along with the 7(a) program's mission to provide credit to those who cannot get it elsewhere.

SBA officials have said and written that lender oversight is becoming an increasing priority for SBA; however, the function is not housed in an independent office with the exclusive role of providing lender oversight. OLO was created within OCA in fiscal year 1999 to ensure consistent and

[19]U.S. General Accounting Office, *Small Business Administration: Current Structure Presents Challenges for Service Delivery*, GAO-02-17 (Washington, D.C.: October 2001).

[20]Also included are leadership continuity and succession planning, and creating results-oriented organizational cultures. U.S. General Accounting Office, *Managing For Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T (Washington, D.C.: February 15, 2002).

appropriate supervision of SBA's lending partners; however, OCA has other objectives, including the promotion of PLP to appropriate lenders. OFA, also part of OCA, is responsible for providing overall direction for the administration of SBA's lending programs, including working with lenders to deliver lending programs, including 7(a), and developing loan policies and standard operating procedures.

OFA's lender oversight role is to provide final approval of lenders' PLP status and to take necessary enforcement actions against SBLCs. Yet, in its promotion role, OFA works with lenders to deliver lending programs. Thus the only explicit enforcement authority—the authority to revoke PLP status—resides with OFA rather than OLO. The presence of both OFA and OLO within OCA does not afford the oversight function an arm's-length position from the promotion function. The organizational arrangement presents a potential conflict, or at least the appearance of a conflict, between the desire to encourage lender participation in PLP and the need to evaluate lender performance (with the potential for discontinuing lenders' participation in PLP).

Evidence of overlapping responsibilities and poorly aligned resources also can be seen in delays SBA has experienced in completing certain tasks associated with lender oversight. As noted previously, these delays could hamper effective PLP and SBLC oversight by delaying corrective action that might arise from review findings. Since some, but not all, responsibility for the lender oversight function migrated from OFA to OLO, both offices continue to mingle responsibilities for certain functions. The division of responsibility between OFA and OLO has created the need for more interoffice coordination to complete certain tasks. For example, we found substantial delays in finalizing PLP review reports and, as noted earlier, in SBLC examination reports.

SBA's IG concluded that the delays in completing SBLC reports were at least partially due to poor coordination between OLO and OFA, both of which were involved in reviewing the reports. OLO and OFA, respectively, are responsible for oversight and management of the SBLC program. OLO is responsible for SBLC on-site examination and off-site monitoring, while OFA handles day-to-day program management, policymaking, and enforcement of corrective actions. Coordination between the two offices, however, was not formally established and simply evolved over time. The IG said that this informal structure contributed, in part, to the delays in issuing the fiscal year 2001 examination reports. OLO staff said that limited staffing also contributed to delays. For example, OLO began

operations with 3 headquarters staff in fiscal year 2000, a number that increased to 12 by December 2002.

We recommended that SBA separate lender oversight functions and responsibilities from OCA, including those currently done by OFA. This would provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight in achieving SBA's goal of ensuring that PLP lenders make loans to eligible borrowers while properly managing the financial risk to SBA. While SBA did not respond directly to this recommendation prior to the December 2002 publication of our report, it recently stated in a response to congressional committees that it believes OLO has adequate independence. In addition, SBA maintains there is an advantage to having both OLO and OFA within the same office and working in concert. SBA did state, in March 2003, that it was in the process of drafting policies and procedures governing OLO program responsibilities. We plan to follow-up with SBA on its response to this recommendation.

Madam Chair, Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

For information on this statement, please contact Davi D'Agostino, Director, Financial Markets and Community Investment, at (202) 512-8678 or Katie Harris, Assistant Director, at (202) 512-8415. You may also reach them by E-mail at dagostinod@gao.gov or harrism@gao.gov. Other individuals who made key contributions to this testimony include Toayoa Aldridge, Tom Conahan, and Barbara Roesmann.

Chair SNOWE. Thank you very much. I am going to look at some of the issues that you have raised. Any response, Ron, at this point to any of those issues?

Mr. BEW. Yes, I am aware of the report and actually one of the four goals that the Administrator set for me was to increase the effectiveness or role of lender oversight when I came here, and we have increased staff there. We have, this month, just awarded a contract through Fed Sim for the loan monitoring system. That should be up and running in about 6 months. That will help us address these problems on lenders, loan programs, products, regions, whatever. It will really help us take an off-the-shelf product from Dunn and Bradstreet and have a more effective oversight policy.

I think we have some items in the leg package for the enforcement policy. We have taken some of those recommendations, most of them, and are addressing them.

Chair SNOWE. Thank you, and we will follow up as well.

Can you tell me, on some of the recommendations here of NAGGL, about centralizing the certification process. Would that complicate oversight at all?

Ms. D'AGOSTINO. Actually, I do not think so. It was also part of our report. We discussed the same issues that NAGGL and some of the banks have brought up about the unevenness that we heard from the lenders across district offices and how it would help them if there was more consistency across.

Chair SNOWE. Thank you.

Let us move on to the Microloan Program. Who would like to begin on that score? Anything? All satisfied?

Go right ahead, Alan.

Mr. CORBET. Thank you, Madame Chair. My name is Alan Corbet and I am the Executive Director of Go Connection, which is a small non-profit in Kansas City, Missouri. We service a geographic area in Kansas and Missouri for the SBA's Microloan Program as well as the SBA's Women's Business Center.

Today I am here to add support to the funding needs of the SBA Microloan Program specifically. We must receive the funding levels necessary to support this program.

We are requesting $25 million in technical assistance grants and a program level of $25 million in loan funds for this program for fiscal year 2004, which supports AEO's recommendations to the Committee. The President's budget has only suggested $15 million for the technical assistance side of that program. I want to speak directly to you about the technical assistance grants today.

For the past 2 years, the approved budgets have reduced the technical assistance grants. If this continues, the SBA Microloan intermediaries will suffer and may eventually go out of business. This is not just about a non-profit going away.

We, as a group across the nation, owe the Federal Government approximately $96 million today on the money that we have borrowed for the benefit of our microborrowers. If we are not in existence, this amount represents a potential loss to the Government. The only way to protect that from happening is to continue to provide technical assistance, as we do, to the small business owners. These are the ones that we have helped out to get in business to begin with.

We would not be making these loans without that assistance in place. These are high risk businesses. In fact, these are non-bankable businesses. The banks will not touch these, and I do not blame them. They do not have the systems in place and they are put together to be profit making and they have returns to their shareholders that they are responsible for.

This program was created specifically to help these high risk businesses to get off the ground. Without the one-on-one business counseling that we provide, they will not exist and they will go out of business.

The SBA guidelines provide that grants will be made to intermediaries of up to 25 percent of the borrowings that we receive from the SBA. This year, fiscal year 2003, we are only receiving 15 percent of that grant. Last year it was 15 percent, and prior to that was 25 percent.

To give you an example, my organization roughly owes the SBA about $1 million and we received $250,000 2 years ago in technical assistance matching grants. This year our grant of $150,000 is a huge reduction to us. To continue the growth that we need to continue, it makes it very difficult for us to manage those accounts that we have on the books.

Based on the suggested technical assistance grants and this year's President's budget for the fiscal year 2004 recommendation, our grant would next year go from 15 down to 11 percent. This is an extremely critical reduction in the funds that we need to monitor and assist these high risk businesses that SBA has encouraged us to help.

If the funding levels in the President's budget is enacted, the future of the Microloan Program is in jeopardy.

As you indicated in your comments earlier, we have over the last 4 years, helped create 34,000 jobs. We handle a market that no other SBA program will handle. There has been some suggestion, and I guess my comments or questions today to you, Mr. Bew, are that there have been some suggestions to us that there is a possibility that the Community Express Program, which is a new program for the SBA, may be an alternative that is cheaper to the taxpayers in order to provide that same dollar amount of loans. That may be true, but it is completely a different borrower. Even the Community Express Program does not go to the borrowers that we assist.

I also understand that there is a need to consolidate technical assistance or grant programs within the SBA and try to get those two—there are several different organizations from the Women's Business Center, Small Business Development Centers, et cetera, SCORE, as well as the Microloan Program, that provides technical assistance. I want to stress the point that, in consolidating these dollars with others of those resource programs, the concern about that is those programs do not have the $100 million at risk that we do to the SBA. When you do not owe the money, you will not help the borrower as heavily as we will.

Those are just a couple of my comments that, if you could respond too, I would appreciate it.

Mr. BEW. As far as the Microloan Program, yes, it appears that TA is down to $17.5 million, I believe, last year, to $15 million. We

are doing a couple of things to make that whole program work more efficiently. One is to give you—it is in our leg package—the flexibility on how you allocate the 25 percent TA, between the old and the new borrowers coming online.

During the course of the year we instituted a performance standard for microlenders. You had to produce four loans per year. Some of the microlenders in the program were not producing as many as four loans, and I think they will not draw the TA which will let us reload that and just use the amounts of money in the Administration's budget more effectively.

Those two items will help us on the microloan. That is our position.

Chair SNOWE. Blake.

Mr. BROWN. Madame Chair, thank you for inviting us today.

Chair SNOWE. The Maine contingency here.

Mr. BROWN. Yes, the Maine contingency. We travel together.

Again, I appreciate your inviting us today.

I am Blake Brown, Chief Financial Officer at Coastal Enterprises. We are a community development corporation located in the great State of Maine.

I wanted to personally thank you for all that you have done for our organization, with all of the SBA programs that we use. That goes from the Microloan Program to the SBA 504 Program through the SBDC and the Women's Business Ownership Technical Assistance Program.

I guess my comments will be very brief. I wanted to play off of what Michael had said earlier about banks having to turn clients down because of various reasons, and they end up going to credit cards and they do not get the counseling that they need. The whole focus of the Microloan Program is to provide that technical assistance to budding entrepreneurs. That is a key link. The financing and TA are a critical piece.

I really think the SBA has a jewel in the Microloan Program. I think the major issue to us is continuing funding for the program.

Over the past 8 years, we have borrowed about $2.8 million from the SBA and have done about $3.6 million of loans, with an average size loan of about $13,000, well below what a bank would typically be looking for. So I think it is really a critical program.

I think Steve would probably concur that a number of our customers have eventually graduated to the bank and we have actually done joint deals. The banks view this program as very beneficial.

A couple of comments. Again, the funding is an issue. CEI, over the last 3 years, have actually had a decline in volume because of lack of funding. Although recently we just received an allocation, which we thank the SBA for gratefully. But basically we pretty much had to slow things down for a good 9 months, and actually elected to borrow money without TA, which we think is not a good thing for us or any of the microloan providers. The TA component is extremely important to the field.

Again, funding level is key. Just a couple of minor points, we would like to see more uniformity in terms of interest rate. That is driven by a number of factors. No. 1, the cost of funds to the microlenders. It would be a much simpler process if we could come

up with a mechanism that blended loans. For instance, we have a series of five loans that range from interest rates of 1.25 points to 6.25 points, a fairly broad range. We are capped in terms of what money we can put out to borrowers.

In the marketplace, we are showing a pretty broad range of rate. We would like to see a consistency in rate. We think that it makes more of a uniform program to the customer.

In terms of eligibility for the Microloan Program, I think we would like to see flexibility in terms of eligibility of organizations apply for funding, and really looking to staff experience and not necessarily organizational-wide experience. Although, again, I think there should be flexibility there.

Again, I think Alan touched on the flexibility of TA and how that gets spent, and I think the SBA concurs with that.

I think those are my key points. Actually, the last one would be eliminating State funding restrictions, although I think the SBA has shown some flexibility there, the way the funds get allocated among States. I think they have been flexible with us in terms of receiving money. But I think I would like to see that incorporated in the laws.

I think that is all that I have. I have written testimony for you.

Chair SNOWE. Thank you Blake, and you can submit the entirety of your testimony. I appreciate those comments.

[The prepared statement of Mr. Brown follows:]

Statement of Blake Brown

Chief Financial Officer, Coastal Enterprises, Inc.

Senate Committee on Small Business and Entrepreneurship

Roundtable on Reauthorization of SBA Credit Programs:
SBA Microloan Program

April 30, 2003

Madam Chair, Ranking Member Kerry and Members of the Small Business Committee, I would like to thank you for this opportunity to be part of this round table discussion of the SBA's credit programs. I would first like to thank you Senator Snowe for all the support you have offered Coastal Enterprises, Inc. over the years and your commitment to strengthening the small business sector in Maine and ensuring that the tools and resources are available to do so.

My remarks this morning are focused on one program that has helped us reach an important business sector in Maine and in rural America, the microentrepreneur, and that is the SBA Microloan program. I would also like to suggest that the Committee consider ways that community based intermediary lenders like CEI can also better serve the needs of small and medium sized businesses that continue to have difficulty accessing financing.

Background: Coastal Enterprises, Inc.

Coastal Enterprises, Inc. (CEI) is a private non-profit, 501(c) 3, community development corporation that provides financing and technical assistance in the development of small businesses, social services and affordable housing. CEI development finance activities are targeted to promising sectors, such as manufacturing, value-added natural resource industries, women business owners, microenterprises, select social services (e.g., child care), environmental technologies and others. In addition, CEI engages in the development of affordable and special needs housing, policy research and advocacy.

CEI utilizes many of the financing and technical assistance tools made available through the SBA and these resources have enabled us to better serve the needs of entrepreneurs and small businesses in Maine. In addition to being an intermediary under the SBA Microloan Demonstration Program, CEI is a licensed SBA 504

certified development corporation, a sub-center under the SBA Small Business Development Center program, a Women's Business Center under the SBA Office of Women's Business Ownership, a certified New Markets Venture Capital Company, and an intermediary under the SBA Women's Pre-Qualified Loan Guaranty Program.

Incorporated in 1977, CEI manages a pool of $107 million in loan funds raised from a variety of public and private sources. CEI funds have leveraged over $480 million in financing for 1,310 small businesses that have created and retained 15,000 jobs. CEI also provides business assistance and training to 1,500 aspiring and existing entrepreneurs each year. In each of its projects, CEI targets social and economic opportunities to low-income people, including welfare recipients and individuals with disabilities. CEI provides a continuum of business finance and support to customers ranging from self employed individuals with limited resources to manufacturing enterprises that employ 100 or more people.

Experience with SBA Microloan Demonstration Program

CEI currently lends throughout the state of Maine with the SBA Microloan Program. Maine's population is predominantly rural; only eight communities within the service delivery area have populations greater than 20,000 and the largest urban area has only 65,000 people. Maine is also a poor state, with a poverty rate approaching 20 percent and unemployment rates as high as 9 percent in some areas and per capita incomes that consistently lag behind those for the rest of the region and the country. Sixty percent of Maine's businesses employ 4 or fewer, and at 12 percent, the state's self-employment rate exceeds the national average.

CEI closed its first SBA loan of $750,000 at the end of September 1992 and has now borrowed a total of $2.78 million from the SBA that has been used to capitalize our microloan fund. As one of the nation's leading microlenders, CEI has made 263 loans totaling $3,642,209 million for an average loan size of $13,848. A total of 475 jobs have been created/retained for a cost of $7,667 per job; a comparable number of jobs are projected to be created over the next three years. Approximately 50 percent of the loans have been to start-ups and sixty-one percent of the businesses are in rural areas. More than half of the businesses represent ownership opportunities for women.

The businesses financed through the microloan program range from home-based child care to small manufacturers of jewelry and toys to construction businesses to retail shops. At least one business has established overseas markets and we have several others that are exploring export opportunities. The owners of microbusinesses in Maine are as diverse as their businesses and include youth entrepreneurs, individuals with disabilities, dislocated workers, single parents, older workers returning to income generating activity after a serious illness, and others.

For some, their business is the sole source of income; for others, business income is combined with other sources to lift a family out of poverty.

The SBA Microloan Program has been an essential source of support for CEI's microenterprise development program. The consistent provision of both lending and technical assistance support over the past decade has enabled CEI to expand its capacity to provide the intensive assistance needed to help these businesses succeed. It has also helped CEI to extend its reach to underserved rural communities and marginalized populations who would not otherwise have access to these critical services.

Role of the Program in Maine's Business Environment

In CEI's experience, there are many new and existing microenterprises who are unable to obtain credit through conventional financial institutions. Although the reasons vary with the individual businesses, in general, microentrepreneurs lack the equity, collateral, track records, management experience and credit histories that bankers look for in extending credit. In addition, women, low-income individuals and minorities are often face even greater difficulties obtaining access to credit

While it is often assumed that most business owners obtain capital from banks, the reality is very different. A survey conducted by CEI in 1991 of Maine businesses with between 1 and 9 employees shows that only 37 percent of the respondents obtained start-up capital from a commercial bank and only 48 percent obtained expansion capital from that same source. This is despite the fact that over 78 percent applied for bank financing. The majority of entrepreneurs rely on personal savings for start-up funds and cash flow for expansion financing. A study of women business owners in Maine conducted by CEI in 2001 revealed that the percentage of women business owners obtaining start-up capital from banks is actually declining. The more recently a business started, the less likely it was to obtain bank financing.

For people with limited resources, the inability to access external sources of capital stifles their ability to start and grow their businesses. The Microloan Program working through intermediaries like CEI responds to this "capital gap" and reaches into a segment of the economy that is overlooked by conventional lenders and traditional economic development strategies. Microenterprise is a business sector that is dynamic and frequently innovative and has demonstrated its potential to generate income and employment for individuals and communities.

However, credit by itself is not sufficient for microbusiness success. The majority of microentrepreneurs are first time business owners without business experience or management expertise. Technical assistance is an important vehicle to help develop the critical skills that can make the difference between business success and failure. Typically, microentrepreneurs require assistance in areas such as

business planning, financial management, recordkeeping, cash flow projections, marketing, hiring and personnel issues, regulatory issues, and financing. Yet access to technical assistance can be as problematic as access to credit for many microbusinesses.

According to CEI's survey, nearly half of the business owners sought advice prior to start-up and approximately 75 percent continue to seek advice for ongoing operations. It is not surprising that resources, such as the Small Business Development Centers and the Service Corps of Retired Executives, are strained and that businesses can wait 4-6 weeks to meet with a business counselor. Seventy-percent of the respondents to a 1995 survey of microenterprise organizations in Maine indicated that the demand for technical assistance exceeded their capacity to respond.

Availability, however, is not the only issue. To be effective, technical assistance must be delivered in a manner that responds to the needs of the owner and is appropriate to the scale and type of enterprise. Approximately 30 percent of the respondents to CEI's survey reported that they had difficulty in obtaining good advice. Among the reasons cited were that service providers did not understand their businesses and were not empathetic. Microbusinesses do not match the profile of the businesses targeted by traditional business assistance resources, whose expertise is often based on experience with existing, manufacturing, fast growing, job generating small businesses. In addition, providing technical assistance to microenterprises tends to be labor intensive, and the needs of individual businesses can exhaust the capacity of traditional resources to respond. Linking the provision of technical assistance to organizations with specific expertise in microenterprise development ensures that the assistance will fit the scale of operations, match the skill level of the owner, acknowledge the impact of the issues of race, gender, transfer payments and resource limitations on business development, and be available on an on-going basis.

Upfront business assistance is essential for the vast majority of microenterprises who need support in the development of business plans and applications for financing. Good business planning can minimize some of the difficulties associated with business start-up, but even the best start-up assistance cannot prepare entrepreneurs for all the contingencies they are likely to encounter as their businesses develop. The availability of technical assistance prior to financing, as well as after credit has been extended, is critical to successful microenterprise development.

By coordinating the provision of technical assistance with the availability of financing and delivering both services through a single intermediary, the Microloan Program responds to the needs of microenterprises for technical as well as financial support. By ensuring the availability of long-term technical assistance, the Program enables intermediaries to develop long-term relationships with their customers and

to provide the consistent, tailored support that reduces business risk and enhances business productivity.

Over its 10-year history, the SBA Microloan Program has demonstrated how the combination of lending and technical assistance can have a positive impact on the success rate of micro-businesses receiving financing through local lending intermediaries. The low loss rates experienced by SBA microlending intermediaries attests to the efficacy of professionally delivered TA in helping emerging businesses to succeed. Under this program CEI's loss rate has been under 5%.

Role of the Program in Relation to the Field

The implementation and development of the SBA Microloan Program has paralleled and contributed to the growth of the field of microenterprise development. The 2002 Directory of U.S. Microenterprise Programs published by the Aspen Institute in collaboration with the Association for Enterprise Opportunity profiles 650 programs in 50 states, which assisted 90,145 non-borrowers and 9,800 borrowers in 2000. Cumulatively, these programs have provided serves to 540,852 participants and $213,879,591 in loans to 34,472 borrowers. The growth of the SBA Microloan Program has helped to stimulate and support the growth in the field.

Recommendations for Program Development

CEI was part of the initial discussions that resulted in the creation of the Microloan Demonstration Program and has continued working with the SBA and Congress since 1991 to strengthen and sustain the program.

The following recommendations are based on CEI's experience as a practitioner and from discussions with other intermediaries across the country.

1. <u>Increased flexibility in the use of technical assistance funds</u>

CEI supports the Administration's position that would give intermediaries greater flexibility in determining how to use technical assistance funds. As mentioned, businesses have individualized technical assistance needs and intermediaries need the flexibility to provide sufficient assistance both before and after an entrpreneur secures a loan. Intermediaries are selected based on their experience and expertise in responding to the needs of businesses and entrepreneurs and we feel intermediaries need the latitude to work with entrepreneurs as they see the needs arise.

2. <u>Eliminate State Funding Restrictions</u>

It is CEI's understanding that there are still restrictions on the levels of funding available to individual states. While previous legislation made progress in

loosening these restrictions, we remain concerned about the impact of a state funding formula as the program grows and the demand for loan funds continues to grow. Areas of high demand and high capacity could be severely constrained. Therefore, we would encourage the elimination of the state funding formula and allowing the SBA to provide loan funds to intermediaries that can demonstrate the demand for funds and the capacity to make additional loans.

3. Uniform Interest Rate

CEI recommends an across the board interest rate for all loans to intermediaries to replace the current system which ties the cost of SBA loans to the 5-year Treasury Bill rate discounted by 1.25 percentage points for regular intermediaries and by 2 percentage points for specialized intermediaries whose loans average less than $10,000.

Many intermediaries have multiple loans from the SBA; each loan has a different interest rate. While interest rates have dropped in recent years, intermediaries are locked into a range of rates for their loans. While not prohibited by statute, the SBA does not allow intermediaries to refinance at a lower interest rate unless the intermediary is in trouble. Refinancing is not an option for intermediaries who want to consolidate their loans and refinance at the current market rate.

A uniform interest rate would simplify administration of the program for both intermediaries and the SBA, allowing for one set of accounts and reporting. As well, it would encourage intermediaries to have more uniform interest rates as lenders if the cost of SBA funds was the same to all intermediaries.

CEI's rates on these loans range from 3.875% to 6.25% with the most recent rates quoted at 1.25%. This disparity requires us to charge quite different rates form customer to customer, creating some confusion in the market place. Having a more uniform rate structure would help eliminate some of the confusion.

4. Eligibility for participation in the Microloan Program

CEI supports increased flexibility in setting eligibility requirements for program participation and generally supports the Administration's proposal to take staff experience into account rather than looking simply at organizational experience when an organization is applying to be an SBA microlending intermediary. CEI would, however, urge the SBA continue to take into account organizational capacity to effectively manage the program when considering accepting new intermediaries into the program.

5. Funding Levels

Despite the fact that the Microloan Program has clearly met the needs of an underserved market and the fact that intermediaries have demonstrated their capacity to deliver the program in a sound and reasonable manner, the program continues to be underfunded leaving the SBA unable to respond adequately to the demand for funds from existing intermediaries. At the same time, the SBA has continued to bring new intermediaries into the program.

It is particularly important that there be an appropriate balance between the amount of technical assistance money and the loan funds that are available. Inadequate funding and increased demand have resulted in a shortfall in technical assistance funds, which has in turn constrained many intermediaries' ability to access new loan funds. In FY 2002, the SBA ran out of technical assistance funds in late spring, effectively hampering the flow of loan funds to the field.

To illustrate the impact that the funding shortfall has had on our ability to deliver the program, one has only to look at CEI's lending track record. CEI made 43 SBA Microloans in FY2001. The number declined to 34 in FY2002, when CEI ran out of loan money part way through the year. CEI submitted a request for additional loan funds in June 2002 and is still waiting. Without funds, CEI has been unable to make any SBA Microloans in FY2003.

In addition, given the shortage of technical assistance funds, intermediaries are asked to take on new loans with little or no additional technical assistance funds. Intermediaries who take on new loans without additional technical assistance funds will have their loan request processed first. CEI has agreed with great reluctance to do this because of its desire to obtain the capital needed to deliver the program but we are concerned about setting a precedent that we do not need the technical assistance funds – we are merely looking to address the needs of our borrowers and taking advantage of the SBA resources that are available.

CEI encourages Congress to provide appropriations that are adequate to support the existing intermediaries and to support the addition of new intermediaries in order to ensure that the program is delivered to currently underserved markets

Intermediary Lending Program Pilot Recomendation

Madam Chair, I would like to switch gears slightly and take advantage of this opportunity to participate in this roundtable discussion on credit programs to discuss another credit gap faced by small businesses that we feel CEI and other community based intermediaries could address if resources were made available.

We share your goal, and the goal of the SBA, in ensuring that small businesses have access to the capital and assistance that they need to succeed. In many cases, we feel

that community based intermediary lenders, like CEI play and important role in providing that financing and technical support to businesses – sometimes in conjunction with a financial institution.

We see a need for larger scale, longer-term, fixed rate financing to meet the credit needs of growing businesses particularly the working capital needs of these business as they transition past the start-up phase of operation. The challenge is to identify source of financing for businesses needing between $35,000 and $200,000. Even though these businesses have developed a track record, they are still often unable to secure conventional financing – In some cases they might lack the collateral required by banks or have credit needs that fall below the threshold set by conventional lenders.

These are not businesses that can be served through other existing SBA loan programs like the 504 or the 7a guarantee for a variety of reason.

The 504 Program can only be used in very limited circumstances for financing fixed inventory purchases, or other costs associated with establishing or expanding a small business. In addition, the SBA 504 loans will only finance up to 40 percent of the total project cost; another lender needs to furnish 50 percent while the business or its owner typically put in 10 percent. Loans of less than $300,000 are typically not supported by the 504 Program because the transaction costs are too high for the lender to justify lending at this amount. During the past 10 years CEI has packaged over $31 million in SBA 504 debentures to 104 borrowers. Our average debenture size is $301,000. Most debentures below $200,000 (i.e. total transaction of $500,000) are not practical due to the costs associated with the program. The 7a Program is also not an option for most of these businesses. While we appreciate that there is an effort to encourage 7a lenders to make smaller loans, the transaction costs associated with a 7a loan work against a bank making many loans under $100,000. While the 7a Program has greater flexibility than the 504 Program in the types of business activities it can finance, the underwriting criteria of 7a lenders would eliminate many emerging small and medium sized businesses with insufficient cash flow and collateral.

While the SBA has programs to support the financing needs of very small businesses and the financing needs of larger businesses, we suggest that there is a gap in services for emerging small businesses seeking between $35,000 and $200,000. While these are not the small businesses that need the intensive technical assistance that microbusinesses require they are often the type of businesses that come to CEI, often through the referral of a financial institution, in need of financing and often the type of business expertise and support that an intermediary like CEI can provide. We recommend that a pilot program be established to allow non-profit, community based lending intermediaries, like CEI, to address this lending gap.

CEI has funds from the Department of Agriculture's (USDAs) Intermediary Relending Program (IRP) that enable us to address the financing needs of rural businesses operating in communities of 25,000 or less. This program has been an important tool that has enabled us to reach small and medium sized businesses in our service area and provide financing often with the participation of a bank lender.

To date, CEI has borrowed $5.75 million in IRP funds from USDA and used those funds to originate $ 8.9 million in loans to 109 businesses in the area. The funds have lead to the creation/retention of 3700 jobs in the state.

CEI's IRP loans range from $55,000 to $150,000 with the average loan request being $85,000. While the IRP has been an incredible resource for some of our businesses – we are limited to communities of 25,000 or less and cannot make this financing available to businesses in Augusta, Portland, Lewiston/Auburn or Bangor. We would like to see the SBA making this type of financing available to businesses through intermediaries like CEI that have a proven track record and can reach businesses that have capital needs that do not match up with existing program guidelines.

We recommend that the Committee authorize an Intermediary Relending Program (IRP) pilot to provide community based lending intermediaries, like CEI, with 1%, 30-year loans to capitalize a small business loan fund to provide credit to businesses needing between $35,000 and $200,000 in financing.

Under this pilot, we suggest that the SBA be authorized to select up to 30 IRP lenders, on a competitive basis, to operate IRP loan funds. Non-profit community development organizations, with a demonstrated track record of working with small businesses and operating loan funds would be eligible to apply And compete for funding and Selected intermediaries would receive 1 percent, 30-year loans from the SBA to capitalize an IRP loan fund targeted to small businesses with capital needs of between $35,000 and $200,000.

Selected IRP lenders would be expected to cover all administrative costs and any technical assistance cost associated with the lending on the interest rate spread between the SBA loan and loans to businesses.

I appreciate the opportunity to present this suggestion to the committee and would be happy to answer any questions that you might have or provide additional information on the proposal.

Mr. BROWN. If we have time, I would like to explore the possibility of creating another lending program within the SBA. We think there is a gap in funding from $35,000 to $200,000 direct lending, that we think could be a beneficial program for the SBA. I really do not want to take up more time with this, but we would love to explore that with you and the SBA.

Chair SNOWE. Great. We will follow up on that, as well.

I am delighted to welcome here today my colleague, Senator Coleman from Minnesota, who is not only a new member of the United States Senate, but also a new member of this Committee. We certainly want to welcome you. We know that he is going to provide invaluable insight and perspective on this Committee. He is also here to welcome one of his constituents, who is Mary Matthews from Virginia, Minnesota.

Senator Coleman.

OPENING STATEMENT OF NORM COLEMAN, A UNITED STATES SENATOR FROM MINNESOTA

Senator COLEMAN. Thank you, Madame Chair.

I should note, a brief aside, I just came from the Senate Floor, in which I had an opportunity to display the Minnesota Golden Gopher tie that Senator Gregg is going to be wearing after Minnesota beat New Hampshire.

I say that because I see the Maine contingent is here, and last year, of course, Minnesota beat Maine in the finals of the NCAA hockey championship. So I have the tie right here.

Mary, being from the Iron Range, that is really kind of the heart of a strong Minnesota hockey country, so it all fits together, Madame Chair.

I am pleased to see that Mary is here today. She is President of Northeast Entrepreneur Fund. It is a community development institution based on Iron Range.

The Iron Range, for those not familiar with it, is up in northern Minnesota. It is a place where we dug out the taconite ore that built the battleships and produced the steel that won two world wars. The reality is that we face some tough times up on the range. Many of the largest taconite producing operations have closed.

Clearly, the future of the Iron Range, the future of the towns, the Virginias and the Hibbings and the Chisholms, is tied to small business being vibrant and vital. That is why what we are doing here today is so important.

I would note that I was an urban mayor for 8 years and had great familiarity with some of the microloan concepts and programs in an urban setting. It is really important to have Mary here today representing a more rural perspective and to highlight the importance of this program.

I think it is very fair to say that the SBA Microloan Program is actually essential to Northeast Entrepreneur Fund's mission. It needs to be there. They rely on the Microloan Program to help those who want to learn how to start a business or to grow an existing business.

I understand that through their work they have helped start or expand over 625 businesses and have created and retained over

1,400 jobs in the region. That is a big deal in a region that has seen significant job loss, this is really, really important.

I think that sometimes the impact the microbusinesses in our economy is often overlooked. For instance, in Minnesota, companies with four or fewer employees employ over 447,000 workers, which is over 13 percent of the total workforce in the state. These are the businesses that directly benefit from the Microloan Program.

So, again, as a former mayor who understood the importance in some of my neighborhoods that we were struggling to preserve and revitalize, creating opportunity oftentimes for new Americans and new immigrants, this program is essential. But it is not just an urban program, it is a rural program.

I want to thank Mary and all the other participants for being here, and I look forward to being very much involved in the work of this Subcommittee.

Chair SNOWE. Thank you very much, Senator Coleman. We appreciate your comments.

Mary, with that introduction——

Ms. MATTHEWS. Thank you, Senator Snowe, for the invitation. Thank you, Senator Coleman, for the introduction. It is a pleasure to be here today.

The Northeast Entrepreneur Fund is a 14-year-old microenterprise and small business development organization serving 10 counties in northeastern Minnesota and one county in northwestern Wisconsin. Our mission is to create a spirit of entrepreneurship, help people start and grow small businesses in a region of the country that is not known for its entrepreneurial spirit.

Senator Coleman talked about the economic dislocation that our region has undergone, and we see a continued, growing interest in small business development.

The Entrepreneur Fund, and particularly the Microloan Program, serves a specific niche in the marketplace, and it is a niche that is not met by banks. It is a niche that is not met by the Small Business Development Centers and other technical assistance providers. That provision of capital through the Microloan Program, as well as the technical assistance, is really a critical link.

To describe that, about 6 weeks ago, our staff looked at our portfolio. We are probably an average size microloan program. We have made 145 loans since 1992 for a total of $1.2 million. Our average loan size is about $8,200.

We have 33 loans in our portfolio. For 85 percent of those loans, at the time when they were made, the business had little or no equity to invest in the business. Two-thirds did not meet bank credit criteria. We have just started collecting credit scores, and of the credit scores that we have been collecting, the highest is 601, the average is about 550. We are actually looking at a loan right now that is below 500. So I am anxious to hear all of you bankers respond to that.

Ninety percent of these businesses were startups. These loans went to startups. Most of them had little or no business experience. Fifty-one percent had no experience in the business they were starting. Would any of you bankers want that portfolio?

Let me tell you how it is performing. The delinquency rate at the end of last month, at 30 days, was 2.1 percent. Our charge-off rate

last year was 3 percent. We have historically charged off about 10 percent of those loans. Early on we were not lenders. As we learned how to be lenders, the performance was not as good at the beginning. It is continuing to improve.

So what makes the difference? The SBA's technical assistance grants tied to the loans invest in business success and it makes it possible for people in a region who have not been starting businesses to start and grow businesses.

Some of them employ themselves. Some over time begin to employ additional employees. Some of those businesses will grow.

I can think of a number of examples where initially the business served a local market. As they have grown confident, their product lines of expanded. We have one business that has been a service business for 12 years and is just starting a second business. It is a manufacturing business that has a regional multistate market, potentially a national market.

This is somebody who is employing all of her neighbors, who works out of her garage, and maybe need to move into a new building.

These businesses grow and they have great potential. However, it is the tie of the training and technical assistance funding that we get from the SBA that makes this kind of performance and this kind of success possible.

So Alan provided the numbers of what the industry request is, and also what the impact is going to be if the administration's budget for $15 million is enacted next year.

There are already organizations leaving the program because there are not enough funds. You cannot separate the two. There is no banker in this room that would delegate monitoring their portfolio, particularly one that I described, to another organization. We cannot give the monitoring and the follow-up to the SBDC. We need to have the funding for both sides of the program.

Part of the difficulty for the SBA is the SBA is divided into two sections, capital access and entrepreneurial training. So this is housed within the capital access side of the program, and there is kind of a disconnect. It is sort of an odd, unique duck, within the SBA environment. Whatever you can do to support the program, its continued growth, and ongoing funding is critical. Thank you.

Chair SNOWE. Thank you, very much. That is very helpful.

Zach.

Mr. GAST. Thank you, Madame Chair.

I think I would like to begin by thanking the SBA for including in their legislation package some changes that were actually brought forth by Senator Kerry and yourself and passed last year in the Senate. I think those are going to be some excellent changes in terms of flexibility, and we would wholeheartedly support those and thank you for working with industry to come up with those changes.

I would then like to turn to a little bit bigger picture. It is easy to focus on the funding and the authorization. Ron Bew cited a statistic that loans of $14,000 are the best job creators. The average loan size in the Microloan Program last year was $14,000.

Beyond that we have more statistics. We have statistics that estimate that the return on investment for the Federal Government for

one dollar invested in microenterprise was $2.06 to $2.72 in either reduced federal expenses or increased federal revenue only. We are just looking at federal. So while you can look at $15 million as quite a bit of money, that is hard to say in the context of the Federal budget, that actually is quite little. When it potentially is returning over two dollars for every dollar that you put in, I would say it is a very worthwhile investment.

Now I would like to focus on the Microloan Program. I think it is a program that is going places and we need to make sure that happens. Nearly one-sixth of all the loans that were made in the program's history were made in fiscal year 2002—and this is a 12-year-old program. It is certainly going places. The quantity of the organizations participating is always improving, and I think we can continue that.

But I think it is been highlighted that the technical assistance is key. These are businesses that need a little bit of help but they can go a lot of places. We just asked for success. We wanted to hear from microloan intermediaries and others. We heard stories of business that started with $10,000 loans in the Microloan Program and now have $13 million in revenue. We heard from a defense manufacturing company that started with a $25,000 microloan and is now doing more than $3 million in business for defense manufacturing.

I would like to point to those and just thank you for the opportunity to be here today and to present the information.

Chair SNOWE. Thank you. Alan, and then Steve.

Mr. CORBET. I would just like to say that my position has been that I am a real champion of small business and of small business. My background is 22 years in banking, but I spent a lot of that time as a supervisory investigator for the Resolution Trust Corporation and that disaster that we had to deal with several years ago.

Getting back to helping the very small businesses has been real exciting for me. I have been doing this for 6 years, but no one ever listens to us. I have my own funding problems in my own community because venture capital is sexy. So people want to talk about that. They do not want to talk about the little $10,000 loan where we help someone get a small cafe started.

I continually struggle to have the people with the money hear about us. The same thing goes to the Federal Government.

So I guess my statement is that I ask you to help send our message to the right Budget Committees and Appropriation Committees, that the funding is provided as we have requested. As Zach indicated, $15 million is pocket change in the Federal budget. So when we only ask for a $10 million increase to restore the previous years' cuts, when it gets to the Committee process and trying to allocate those monies, it becomes very difficult to get those earmarked to our program.

I implore you to help the very, very small business owner of America to get the funding that we need to help them out.

Chair SNOWE. I know exactly what you are saying. You can certainly have a greater bang for your buck with these types of programs, especially at a time in which we have a declining economy.

Small business is the engine that drives the economy, without question.

It seems counterproductive not to be investing more in these programs, because it really does maximize the effect. The only job creation that is occurring is from small business. It really does not make sense to be ratcheting back these programs at a time in which we need job creation.

To me it really is staggering, when I look at these numbers, the respective programs within SBA and to see the thousands of jobs that it ultimately generates.

Essentially, I think those of us serving on the Committee and maybe some others, and obviously all of you, understand. However, I do not think people can fully appreciate, and even I did not until I was looking at these numbers, the extent to which these programs become a great catalyst for job creation in our society. They really do produce.

I think we really have to do more to advance these programs. You are right, for a small amount of money we can get so much from them. So I would like to do more in that regard, without question.

Steve, and then I have to go. I do not know if I will leave it with Norm or just leave it with the staff to continue the discussion for the rest, because I want to make sure you all have the opportunity to fully participate in any other aspect. I am sorry that I have to depart.

Senator COLEMAN. I can stay for a little bit.

Chair SNOWE. Great, that would be terrific.

Mr. BYRNES. I would just like to throw my support behind the Microloan Program. It is administered through CEI in the State of Maine.

Over the last 6 months we have had two specific transactions. Both were women-owned businesses that were acquiring a retail shoe outlet and a restaurant. In both of those transactions, there were not sufficient proceeds after the bank loan and the equity contribution from the women-owned business owner. We had to turn to CEI as gap financing to provide a microloan.

I can say with complete honesty that if the microloan was not there to provide that gap financing, both of those transactions would not have happened. Many times at the 12th hour, those microlenders can turn these transactions around in a very short period of time. Because you have situations that no one can anticipate, such as a light evaluation on the assets or an appraisal that comes in light, and you have a gap that is created in the 12th hour.

The CDCs and the CDFIs do a great job of providing that gap financing in critical situations like that. It helps move that 30 percent number for women-owned businesses up to an even higher level.

Chair SNOWE. Thank you.

I just want to express my appreciation to all of you for the thoughtfulness that you have brought to the table with respect to your recommendations, and I can assure you we are going to follow up on each and every recommendation that has been presented here today, and to vet them further as we proceed to reauthorization, working with Senator Kerry. We have a great working rela-

tionship, and I know we will continue to do that. With members like Senator Coleman on the Committee we hope to have a very good reauthorization process that I think everybody can be proud of.

I just want to thank each and every one of you. All of your testimonies will be submitted for the record in their entirety.

Thank you, Senator Coleman.

Senator COLEMAN. Thanks and I will take it from here, if there are others that still wanted to speak.

Ms. MATTHEWS. Thank you, Senator Snowe, again for the opportunity. Thank you, Senator Coleman.

In fiscal year 2003, that is our current budget, right? The $15 million that has been appropriated for the SBA Microloan Program means that there are limited technical assistance grants for new loan capital. Blake referenced the fact that CEI has just taken on a loan with limited technical assistance to support preparing borrowers to access financing. So that is going to limit the ability to grow the program.

We created some projections about what the technical assistance grants need to be between now and 2000 and fiscal year 2007. In order to continue to grow the program and continue to serve new loans, the amount of appropriation for the technical assistance grants needs to increase because we are bringing on new loans. We are also supporting and providing ongoing assistance to past loans.

[The information follows:]

Technical Assistant Grant Amounts of SBA Microloan Program to fund Borrower Support Activities

SBA Microloan Program
Projections - April 29, 2003

	(millions)			TA Grant calculation to intermediaries 15%	20%	25%
FYE 2002 SBA Loans Receivable to Intermediaries	$ 95.6	actual				
Principal Repayment (10%)	$ 9.6	est.				
News Loans	$ 25.0	est.				
FYE 2003 SBA Loans Receivable to Intermediaries	**$ 111.0**	est.				
Principal Repayment (10%)	$ 11.1	est.				
News Loans	$ 25.0	est.				
				(millions)	(millions)	(millions)
FYE 2004 SBA Loans Receivable to Intermediaries	$ 124.9	est.	TA	**$ 16.66**	$ 22.21	$ 27.76
Principal Repayment (10%)	$ 12.5	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 3.75	$ 5.00	$ 6.25
			FY04 Grants	**$ 22.61**	$ 29.41	$ 37.01
FYE 2005 SBA Loans Receivable to Intermediaries	$ 142.4	est.	TA	$ 18.74	$ 24.99	$ 31.23
Principal Repayment (10%)	$ 14.2	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 3.75	$ 5.00	$ 6.25
			FY05 Grants	$ 24.69	$ 32.19	$ 40.48
FYE 2006 SBA Loans Receivable to Intermediaries	$ 158.2	est.	TA	$ 21.37	$ 28.49	$ 35.61
Principal Repayment (10%)	$ 15.8	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 4.50	$ 6.00	$ 7.50
			FY06 Grants	$ 28.07	$ 36.69	$ 46.11
			TA	$ 23.73	$ 31.64	$ 39.55
			NTAP'	$ 2.20	$ 2.50	$ 3.00
			TA-new loans	$ 4.50	$ 6.00	$ 7.50
			FY06 Grants	$ 30.43	$ 40.14	$ 50.05

Note: TA = Technical Assistance
NTAP = Non Lending Technical Assistance

The President's Budget suggests $15 million for TA. This means Intermediaries will only receive approximately 11% This level of funding to the Intermediaries will threaten the Intermediaries survival. Eventually, Intermediaries will go out of business. This puts the Intermediaries Notes Receivable payable to the federal government at risk.

Ms. MATTHEWS. The other thing that I think is critical to note is that the program has been authorized for $70 million in technical assistance funds and $100 million a year in loan capital. With these requests, we are still way below what has been requested for the program.

It is also not available across the country. It is available in about two-thirds of Minnesota, the central piece of Minnesota is not covered. There are a number of pockets throughout the country where there is not yet an SBA Microloan Program. So in order to have this available across the country to grow small businesses, we are going to need to add additional intermediaries and, as a result, additional funding.

Senator COLEMAN. Mary, may I ask you, or perhaps someone from the SBA, what is the reason or the basis for, let us say in Minnesota, the areas in which there is not coverage? What is the reason for that?

Ms. MATTHEWS. There are actually six intermediaries in Minnesota, two in the metro area and four in rural Minnesota. There needs to be an organization that is taking on the program. The four outer corners of the State are covered by intermediaries and then there are two in the metro area.

There have not been organizations that have requested the program as of yet.

Mr. BEW. I think I can respond a little bit to that. I believe you are aware of the leg package where we are asking for flexibility and experience to encourage some other people to be microlenders, other entities. Hopefully that will be cured, particularly in the rural areas.

Ms. MATTHEWS. It will not be cured if there are not the technical assistance grants to support that.

Mr. BEW. I hear that. I have got the message.

Ms. MATTHEWS. One of the difficulties that we have had, as a matter of fact, is that as funding has been declining, the SBA has been bringing in new organizations. So the pot that was getting smaller is spread among more people. It makes it more and more difficult to work.

We all look for alternative sources of funding. We all look at streamlining our process and making changes that will—while not as efficient as the Express Program—hopefully make us more efficient. However, we still need more funding in order to provide the kind of support that business owners need.

Senator COLEMAN. Thank you, Mary.

Mr. WARREN. Senator Coleman, we really appreciate you stopping by today.

We obviously have more time that we can spend on microloans, but I think we also do, before we conclude, need to go back because I think there were some issues left open on the 7(a) side of things.

One question that I wanted to ask Ron, if you could add into, and then the group as well, the Administration's proposal includes some changes to the amount of experience that a microlender would have to have. I was wondering if you could comment on a proposal.

Mr. BEW. I think that is what I was alluding to with Mary, that there is an experience requirement—I do not know exact details of

it—that precludes other entities from joining the Microloan Program immediately. I think there are some years of experience requirements.

We are proposing that if entities have people with experience that the microlenders need or have, then it would accelerate that entity's ability to join the microlending program.

Mr. WARREN. I guess the question for us would be has that current restriction presented a significant enough bar? Does that raise additional issues in terms of having an organization with no organizational experience, yet having somebody come from another organization that has the 1-year requirement? Is that going to create new potentials for problems?

Mr. BEW. I am not sure about the creation of problems. I do not believe so, because the entities that would probably ask to be a microlender are already lenders. It could be a 504 lender, for instance, and already have experience in the field but just do not have that specific microlending experience.

Mr. GAST. If I could make one comment, there is currently a provision in the legislation that asks the SBA to provide capacity building services through a grant to a non-profit organization that would allow the SBA to bring people up to speed very quickly, if people were able to go in and provide intensive assistance.

Up until now, that has not occurred. Obviously, that is something the industry would like to see—is the opportunity to work with people and bring them up to speed so that we can get full coverage across the country.

Ms. FORBES. That is Senator Snowe's amendment to S. 174, the bill that passed the Senate last Congress, right?

Mr. GAST. Actually, that was separate. There is a provision currently in the legislation, and I believe Senator Snowe introduced a second provision that would add $1 million for that purpose.

Mr. CORBET. I just had a couple of comments. I guess the only comment was the subsidy rate, I know what the rate is. What I don't know is how it was derived.

I would ask the Committee to look into that regarding the Microloan Program subsidy rate. Ron, maybe you can explain it. It confuses me.

But I think most specifically, we have seen the subsidy rate for the microloan program going up, and I know that is what helps decide the President's budget and what they allocate. We do not quite understand why it is going up, because as far as the loan volume that has been lent to the intermediaries, there has been no loss, or maybe a minimal loss to the Federal Government in that program, but the rate continues to climb each year. Whereas the Disaster Loan Program, which has significant defaults, has been declining in its subsidy rate.

I hate to get into this too far, because I do not know enough about it except just what the rate says, but I would ask the Committee to look into that to see if there is any rectification.

Mr. WARREN. Ron, do you want to comment on that?

Mr. BEW. I think I will leave that to the Chief Financial Officer. I am like you, Alan. I was a banker most of my life, and I have never heard of subsidy before I came here.

Ms. FORBES. Can I just clarify one thing? To our knowledge, there have been no losses to the Government in this program since its inception. Is that still accurate, Ron?

Mr. BEW. I think there has been a minimal amount of loss.

Ms. FORBES. So an intermediary——

Mr. BEW. An intermediary, yes, defaulted.

Ms. FORBES. Can you submit that to this Committee, so that we see it? Because we are not aware of that.

Mr. BEW. But it is very minor.

Mr. SCHUSTER. Thank you, Mark.

I would like to just return to a general discussion of the impact of the total SBA loan programs. As we all know, OMB has too often taken an annual look at this program. Let me cite an example.

A few years ago a Congressman in my district, on the night of his election, said, "We are going to consolidate and eliminate some agencies". The one he mentioned was SBA.

I had him come into my office after obtaining from the local SBA district a computer printout of every single loan made in that district since 1953. This new Congressman spent 2.5 hours going page by page which was—he could not believe all businesses that one time or another in their life had received assistance from the SBA.

I think we, as an industry, the Committees, and the SBA need to focus more on the cumulative impact of these programs rather than the 1-year snapshot. There is not a story here that would not be dramatic 10 years from now.

As this Congressman, who has become a great supporter of SBA, said once, "If you removed all of the businesses from our economy that at one time or another received SBA assistance, it would be a major impact on this country's economy". Somehow we have got to get OMB and SBA to focus on that.

While I am on that, let me just put on the record, we need to also recognize that it is the large loans that "subsidize" a lender's ability to do smaller loans or the Agency's ability to do smaller loans. We need to come to grips with that. There is no question, but the income generated under the 7(a) Program by the borrowers that pay the 3.5½ percent guarantee fee, do help create an environment and a subsidy rate and affordable loan program for the smaller ones.

Then, to just put another hat on, a few years ago the Agency had a direct loan program called HAL or Handicap Assistance Loan Program. It then was changed to Disabled Assistance Program but not funded. I think now it has been removed.

But just so everybody would focus on it, back years ago, when there was a HAL Program, I am familiar and on the board of an organization that received two HAL loans. Today, they employ over 200 people, of which 75 percent are severely disabled individuals who prior to this program were wards of the state. Their total lifestyle was dependent upon government handouts. They are now contributors to society.

As a point of interest, they were the sole source for every M–16 magazine used in the recent war. It is an incredible success story. Those are the kinds of things I think SBA and the Committee need to focus on, look to the future, and to sell people on. SBA is, in fact, the greatest bang for the buck in all of Government.

While we have some minimal disagreements from time to time, I too take my hat off to the professionals at SBA.

Mr. WARREN. Thank you. Not seeing any other placards—I am sorry, David.

Mr. BARTRAM. Thank you very much, Mark.

I would like to go back to the possible, or what we believe to be, a real shortfall for next year. Ron Bew has basically stated that the Administration feels comfortable with the funding levels for next year. If we did see a trend where funding levels are significantly higher than they think for this current fiscal year, what would the SBA's position be starting next year?

I would maybe ask it and give you an option, Ron. No. 1, would the SBA immediately be forced to put a cap in place as of 10/1/03? Or, realizing that maybe they had miscalculated, would the SBA push or suggest that perhaps additional appropriations are required to find an inadequate, or what would basically be supported to be inadequate at that time, 2004 budget?

Mr. BEW. Of course, we think the $9.3 billion is adequate and we would just review the situation at that time.

Mr. BARTRAM. But what if you are wrong?

Mr. BEW. We would just review the situation at that time.

Ms. FORBES. Can I just comment that if it is October or later when the situation is determined to be a problem, SBA has missed the appropriations cycle. So it would be very hard, unless there was another supplemental appropriations request coming up, to secure additional appropriations and then if the supplemental request were limited to defense, for example, or homeland security, it would be very hard to get this kind of money onto that bill.

Mr. WILKINSON. We should have an indication over the next few months if we are experiencing the cycle that we have experienced for the last 10 years or so, with the second half loan volume being bigger. They should have a pretty good indication over the next couple of months whether loan volume is going to be at a pace higher than what is in the next year's budget request.

Mr. WARREN. If I could, before we wrap up, I would like to go back to Greg. You have talked a lot about the pooling idea, or a few minutes on it. How would that mesh with the current 7(a) structure?

Mr. FELDMANN. The concept that we have advanced and left for the record would be, again, a complement for the 7(a) structure as supposed to supplanting it in any way. The idea would be to follow the same track that the SBA does with SBICs. You could license some pooler/aggregators who could then purchase and use a limited, probably second loss position, to guarantee from the SBA in order to credit enhance that pool and sell it on into the capital markets.

We think that there would be institutional buyers. We know, from talking to community banks, that they would be interested in using this as a potential vehicle to address liquidity concerns.

Currently, if you look at the community banks say between $100 million and $1 billion in the United States, they are at a 40-year high in terms of loans versus core deposits. They are struggling with funding and keeping up with funding right now, and I think

probably some other colleagues here can address that even better than I could.

But again, one piece of data that might be interesting to this Committee, we have made an estimate in that same segment of community banks that there are roughly $100 billion worth of real estate-backed small business loans, owner-occupied properties and that sort of thing. I think that type of debt would lend itself, as an initial block of debt, that could be pooled and aggregated and sold onto the market.

However, we do feel that there is some sort of a credit enhancement role to jump start that process, since it is a fairly new asset class.

Mr. WARREN. Anyone else want to chime in on that?

Ms. FORBES. I have a question. When you are talking about a credit enhancement role, do you have something in mind? Do you have a price that goes with that?

Mr. FELDMANN. Again, conceptually, the idea would be that there would be a first level loss reserve that would be created at the private level. Then a second level loss reserve that the SBA would provide, maybe in the 3 to 5 percent range of the pool, something like that.

But you would go through the private first level loss reserve before you would ever hit the second level.

Ms. FORBES. Would the first level be the same percentage as that proposed for SBA's contribution, or would it be a lower percentage?

Mr. FELDMANN. It could be the same, or maybe even slightly higher. That is something, I think, that would have to get structured in the details and more discussion.

But the idea would be to get a lot more bang for your dollar. In the current 7(a) Program, you are providing up to a 75 percent loan guarantee, whereas I think under this structure you could cap out at a much lower percentage of potential loss than you would in the 7(a) Program conceptually.

If you look again on the record, we have kind of outlined a little plan that I think a lot of detail would have to be fleshed out on. But on page 12 of our presentation that is part of our record, we lay that out.

Ms. FORBES. Can you estimate a cost for that? You are proposing some sort of cost.

Mr. FELDMANN. Yes. I think the pooler/managers would charge a fee necessary to meet any cost at the SBA for the credit enhance. So there would be a wash. There would be no cost to the SBA, and that would be the concept.

Ms. FORBES. There would be no cost to run it, but there would be a cost of the credit enhancement; correct?

Mr. FELDMANN. That is right.

Ms. FORBES. That is what I am trying to ask, what are you estimating for that?

Mr. FELDMANN. What I am trying to say is I think the pooler/aggregator would charge a fee as they pool those loans sufficient to meet any cost that the SBA would have for the credit enhancement. So it would wash.

Mr. HEARNE. So it would make this like a zero subsidy type of program?

Ms. FORBES. Somehow you have to have something up front to start it, right? Do you have any estimates on that? You can submit it for the record.

Mr. FELDMANN. I think that is something that we may want to think about offline.

Ms. FORBES. What I am trying to do is identify the amount relative to what is spent on 7(a).

Mr. WILKINSON. Mark, if I could just comment briefly on the pooling concept.

We have not been briefed, so we do not know the details. But I would say that in the past we have looked at various and sundry ways to supplement the 7(a) Program and really have not found anything that worked. We went, I do not know how many years back, we looked at a Government-sponsored enterprise and we just could not find a way to make all the pieces of the puzzle fit together.

We would have some concerns as to whether this was actually pulling out what we would call the grade A credits out of the 7(a) portfolio, which would then ultimately cause the subsidy rate in the 7(a) Program to rise. So you would start a vicious cycle. I am not saying that would happen because I do not understand the intricacies of this deal.

One of the other items that we have picked up on as we looked at some of these alternatives was the reason that this program is doing well is that we have got a program that works for the borrowers, and is profitable for the lenders. It is a good match.

From my understanding of a program like this, it becomes profitable for the pool assembler and that there would be a diminished demand by the lending community. That is one thing we would have to cross over, are you putting together a program for pool assemblers, as opposed to the ultimate borrower?

Mr. WARREN. Greg, did you have any other comments on that?

Mr. FELDMANN. I am not a pooler/aggregator. I am just simply saying that from our experience we are seeing tighter liquidity issues in the community banks and it is creating a constraint. I think this is one way we have seen other asset classes successfully cross this divide. I think the case can be made, although further study would be required, that there is a capital market sufficiency in terms of cost to borrower that would come to bear over time.

Mr. WILKINSON. There is a very active secondary market that, for the 7(a) Program, provides great liquidity, that is working quite well. I would be a little shocked that there is a liquidity crisis right now. I think most banks are flush with deposits.

Mr. BARTRAM. Only 38 percent of the SBA loans are sold. So that does not support that there is a liquidity issue.

Mr. FELDMANN. Again, I am not saying that you would sell the SBA loans. I am saying that there are other blocks of loans inside these institutions that could qualify. So I am not sure that we are at competing odds here.

Mr. WILKINSON. As long as it is not a replacement for, and that is what has been said several times, that it is in addition to. That said, we are staring at a budget shortfall next year, and we are going to have to find ways to solve that problem.

We have got a legislative package we are going to submit. You may see some additions to that as we get farther down the road. If it appears that the Agency is not going to come forward with a supplemental budget request, or if we cannot handle the appropriation process to come up with additional funds, we may have to come back and revisit some of the program parameters and have some new ideas at some point in time.

Mr. BARTRAM. Mark, if I could just add, one way to augment part of this shortfall is to get the STAR money rescored, and that just boggles the mind.

Mr. WILKINSON. An absolute must.

Ms. FORBES. Ron, do you know what happened to the response to Senator Snowe and Senator Kerry's letter on the STAR rescoring? It was sent about a month ago. We had asked for a return within a pretty short time. I think it was a week or less.

Mr. BEW. I am not sure where that is. I do know that we are reviewing the STAR rescore.

Mr. WARREN. If you could look into that, because I know Senator Snowe has asked repeatedly for it, as well as Senator Kerry. We would very much appreciate a reply on that.

Ms. FORBES. The only other point that I was going to return to was GAO. Davi, I know that you have been working hard on our requests and both sides of the Congress really appreciate it. Everybody appreciates all the good work that you and your office do for us.

But I would like you to talk a little bit about some of the problems that you have had in getting information to validate the econometric model. We are all delighted that the econometric model is there and that it is seeming to be a better model, but we want it validated. Senator Kerry is very interested in that.

Ms. D'AGOSTINO. As you know, you all and the House Committee requested that we very quickly look into the new credit subsidy model and try to explain some changes that occurred through different iterations, and then to also look in more depth and verify and validate the model.

I think we reported fairly quickly in January to you all in a briefing about some of the things you asked us to do, and then began to undertake the more in-depth work, pulling about the model which is fairly complex.

What has happened is things have somewhat changed at SBA. We have always had a great working relationship with basically all the program offices and the CFO. Our work seems to be taking a turn for the slower, at a minimum. The new liaison for GAO is the CLA and they have put in place some fairly cumbersome procedures for our work that has slowed our work to a point where what would normally take 3 to 4 months is now going to take 9 months or more, and it is hard for us to even estimate now when we could complete that work.

Some of the examples, all communications must go through that office. Meetings have to be scheduled so that their staff have to be present, even if other times are more convenient for both the SBA program officials and GAO staff.

Also, there are cases where we are not getting timely or complete information in response to our requests, and we do have to keep

going back and asking for the complete information or documents in basically all our work, not just the work on the 7(a) credit subsidy model. We are also doing work for Chair Snowe and others on the transformation initiatives, et cetera.

It is just becoming more and more of a challenge to meet the time frames that you all ask us to meet. It has become difficult.

We cannot even make a commitment to the Committees about when we could complete the work, given the process that we are having to go through.

Mr. WARREN. This may be an issue that is broader, Ron, than your shop, but I think it is something that we need to address. Ron, we will be asking, possibly the Administrator, to help us work through that, because obviously the GAO is an incredibly important asset for Congress. In order for you to do your work, you have got to have access to the information. That is all we are really asking for.

Ms. D'AGOSTINO. I would like to add that GAO is trying to work with SBA and we are going through the process right now and probably will end up talking with the Administrator. We have a few more steps to go through, I think, before we get there. But we are trying to work out some different operating procedures so that we can get our work done.

Mr. WARREN. If you could keep us informed on that.

Ms. D'AGOSTINO. Sure.

Mr. WILKINSON. Mark, could I just echo, we have the same kind of issue on the flow of information. This is nothing against Ron and his staff, but the flow of information has stopped.

I have got a couple of e-mails that have come in and says we are no longer allowed to talk to industry. A memo went out of central office a week or two ago that said working with lenders was not considered mission critical. There appears to be, at the management level somewhere, a demand that says no information flows out of the Agency.

It has stopped flowing in our direction, as well.

Mr. WARREN. We have just about wrapped up our time. I want to thank everybody on behalf of Senator Snowe and Senator Kerry, if I can, for coming to the roundtable.

Obviously, we have heard a lot of good suggestions, identified a number of problems. Clearly, we have quite a bit of work to do.

As Senator Snowe said at the beginning, the record will remain open for 2 weeks. If you have additional information, things you want to supplement for the record, please feel free to send them in. Probably the best way to do it is to either e-mail or fax to our hearings clerk, who will get them into the record.

We also may submit some written questions to you on behalf of the members, and we would ask for your timely responses on that.

With that, we are adjourned. Thank you.

[Whereupon, at 11:36 a.m., the roundtable was adjourned.]

APPENDIX MATERIAL SUBMITTED

Submitted Testimony of
Ron Bew, ADA Capital Access
US Small Business Administration
On the 7(a) and Microloan programs
Committee Small Business and Entrepreneurship

I am proud to be here and have a chance to tell you about the Capital Access programs for the SBA. I believe that our agency has a unique position to serve the American public and impact employment. By working for the interests of small business, we serve the country as a whole.

Working on behalf of small business is a non-partisan issue. Both Democrats and Republicans know the impact of small business on our nation's economy. My role in overseeing the Office of Capital Access is to help expand economic opportunities for all Americans. For some that means granting the dream of starting a new business and for many it means creating jobs to feed families and contribute to a growing economy.

I believe the Administration's purposed budget for 2004 will allow us to continue the work that we started. We have hit record highs in our 7(a) lending program and are looking to increase the number of loans with our FY04 appropriations.

Last year SBA guaranteed 51,666 loans that created or retained 370,000 jobs. Our goal for FY03 is 60,000 loans and FY04 is 72,000. With the adoption of the econometric credit subsidy model, and funding levels at $9.3 billion, we will accomplish that goal.

We firmly believe that the Administration's request will allow SBA to serve the needs of small business when combined with available private sector financing. Our historic gross daily average from 2000-2002 has been $37.5 million per day. When multiplied out for the year, this will give us $9.3 billion dollars.

2000 - $38.5 p/d
2001 - $36.5 p/d
2002 - $37.5 p/d

This year's volume has followed this same trend and exhibits no signs of significantly increased demand. We believe, therefore, that the SBA budget is in line with the historic usage level of the program, and will be adequate for FY2004.

When I came aboard, I was given the job of increasing the number of small loans to growing businesses. Not only does increasing the number of small loans reach a greater number of businesses, but we also see a greater impact on job creation with smaller loans.

SBA, working in conjunction with Bureau of Labor Statistics, studied the impact of SBA lending in job creation. The results reveal that smaller loans create more jobs then the larger loans. In fact, loans under $50,000 have the greatest return in the number of jobs created. This is one more indication that our goals will continue to create greater

employment to assist in the recovering economy. While some would argue that 7(a) is not a "job creation" program we believe it would imprudent to ignore these statistics.

Strata by size of loan	strata definition	job coeff
1	1-49,999	14,717
2	50000-149,999	32,535
3	150,000-249,999	61,399
4	250,000-499,999	96,250
5	500,000-999,999	153,780
6	>= 1M	140,490

Jobs Created and Retained as Reported* on 7(a) Loans
Stratified by Loan Size and Percent of Total Dollar Volume

size	2000		2001		2002		2003**	
<50K	32,467	2.06%	41,112	2.33%	60,405	2.57%	23,283	4.68%
50K-149,999	82,988	12.81%	80,913	13.37%	99,828	11.99%	28,395	17.07%
150K - 249,999	56,420	11.96%	52,273	12.21%	48,177	10.75%	11,580	13.59%
250K - 499,999	65,166	21.34%	62,666	20.73%	62,519	18.71%	16,578	24.71%
500K - 999,999	60,391	28.50%	51,953	27.52%	60,025	28.23%	9,382	21.86%
I Mil+	42,310	23.33%	34,251	23.85%	43,858	27.75%	4,390	18.10%
Grand Total	339,742		323,168		374,812		93,608	

* Because job creation and retention number are not required by the 7(a) program, not all businesses have reported actual numbers are understated.

Additionally, we continue to increase access to smaller loans through the 7(a) program. So far in FY03, 7(a) loans under $50,000 account for 44% of all loans guaranteed. We have made great progress in a number of our goals including a 44% overall in our lending to women and minorities, when we combine both 7(a) and 504 loans.

Here are some brief numbers in our overall lending:

An increase of 37% to women
25% to veterans
39% to Hispanics
79% to African Americans
35% to Asians
26% to Native Americans

We are also increasing our lending percentage to startups which are 62% ahead of last year in making loans under $150,000.

Our FY04 budget is also requesting $20 million dollars for micro-lending and $15 million for technical assistance for those borrowers. This is an underserved market, for borrowers that would not traditionally qualify for a bank loan. The program produces results, and last year we estimated that the program created roughly 4,000 jobs.

We are proposing several changes in our legislative package that will allow the program to better serve this targeted market. In FY2003, SBA instituted a plan to increase the performance standard of intermediaries in our program. Lenders would have to make a minimum of 4 loans per year for continued participation. This has reduced the number of intermediaries in the program but we believe will result in lenders who are dedicated to the goals of the Microloan program.

We believe that these standards, when combined with the additional flexibility for technical assistance will allow microlenders greater opportunities to assist more early stage entrepreneurs. Our agency is also seeking to amend the experience requirement for becoming a technical provider. By allowing organizations to hire experienced lending professionals, participants will be able to also better serve this market.

I have been at the SBA for just over a year. In that time, we have made some great strides forward in making our programs more efficient and accessible. When I came aboard, I committed to a number of issues: Increasing outreach to underserved markets and increasing the number of loans to growing businesses. I am happy with the progress we have made and look forward to expanding on these accomplishments. Our lending partners have responded enthusiastically to our initiatives, particularly SBAExpress and we expect to continue working with them to improve our performance on behalf of small business.

Statement of Blake Brown

Chief Financial Officer, Coastal Enterprises, Inc.

Senate Committee on Small Business and Entrepreneurship

Roundtable on Reauthorization of SBA Credit Programs:
SBA Microloan Program

April 30, 2003

Madam Chair, Ranking Member Kerry and Members of the Small Business Committee, I would like to thank you for this opportunity to be part of this round table discussion of the SBA's credit programs. I would first like to thank you Senator Snowe for all the support you have offered Coastal Enterprises, Inc. over the years and your commitment to strengthening the small business sector in Maine and ensuring that the tools and resources are available to do so.

My remarks this morning are focused on one program that has helped us reach an important business sector in Maine and in rural America, the microentrepreneur, and that is the SBA Microloan program. I would also like to suggest that the Committee consider ways that community based intermediary lenders like CEI can also better serve the needs of small and medium sized businesses that continue to have difficulty accessing financing.

Background: Coastal Enterprises, Inc.

Coastal Enterprises, Inc. (CEI) is a private non-profit, 501(c) 3, community development corporation that provides financing and technical assistance in the development of small businesses, social services and affordable housing. CEI development finance activities are targeted to promising sectors, such as manufacturing, value-added natural resource industries, women business owners, microenterprises, select social services (e.g., child care), environmental technologies and others. In addition, CEI engages in the development of affordable and special needs housing, policy research and advocacy.

CEI utilizes many of the financing and technical assistance tools made available through the SBA and these resources have enabled us to better serve the needs of entrepreneurs and small businesses in Maine. In addition to being an intermediary under the SBA Microloan Demonstration Program, CEI is a licensed SBA 504 certified development corporation, a sub-center under the SBA Small Business Development Center program, a Women's Business Center under the SBA Office of Women's Business Ownership, a

certified New Markets Venture Capital Company, and an intermediary under the SBA Women's Pre-Qualified Loan Guaranty Program.

Incorporated in 1977, CEI manages a pool of $107 million in loan funds raised from a variety of public and private sources. CEI funds have leveraged over $480 million in financing for 1,310 small businesses that have created and retained 15,000 jobs. CEI also provides business assistance and training to 1,500 aspiring and existing entrepreneurs each year. In each of its projects, CEI targets social and economic opportunities to low-income people, including welfare recipients and individuals with disabilities. CEI provides a continuum of business finance and support to customers ranging from self employed individuals with limited resources to manufacturing enterprises that employ 100 or more people.

Experience with SBA Microloan Demonstration Program

CEI currently lends throughout the state of Maine with the SBA Microloan Program. Maine's population is predominantly rural; only eight communities within the service delivery area have populations greater than 20,000 and the largest urban area has only 65,000 people. Maine is also a poor state, with a poverty rate approaching 20 percent and unemployment rates as high as 9 percent in some areas and per capita incomes that consistently lag behind those for the rest of the region and the country. Sixty percent of Maine's businesses employ 4 or fewer, and at 12 percent, the state's self-employment rate exceeds the national average.

CEI closed its first SBA loan of $750,000 at the end of September 1992 and has now borrowed a total of $2.78 million from the SBA that has been used to capitalize our microloan fund. As one of the nation's leading microlenders, CEI has made 263 loans totaling $3,642,209 million for an average loan size of $13,848. A total of 475 jobs have been created/retained for a cost of $7,667 per job; a comparable number of jobs are projected to be created over the next three years. Approximately 50 percent of the loans have been to start-ups and sixty-one percent of the businesses are in rural areas. More than half of the businesses represent ownership opportunities for women.

The businesses financed through the microloan program range from home-based child care to small manufacturers of jewelry and toys to construction businesses to retail shops. At least one business has established overseas markets and we have several others that are exploring export opportunities. The owners of microbusinesses in Maine are as diverse as their businesses and include youth entrepreneurs, individuals with disabilities, dislocated workers, single parents, older workers returning to income generating activity after a serious illness, and others. For some, their business is the sole source of income; for others, business income is combined with other sources to lift a family out of poverty.

The SBA Microloan Program has been an essential source of support for CEI's microenterprise development program. The consistent provision of both lending and technical assistance support over the past decade has enabled CEI to expand its capacity to provide the intensive assistance needed to help these businesses succeed. It has also

helped CEI to extend its reach to underserved rural communities and marginalized populations who would not otherwise have access to these critical services.

Role of the Program in Maine's Business Environment

In CEI's experience, there are many new and existing microenterprises who are unable to obtain credit through conventional financial institutions. Although the reasons vary with the individual businesses, in general, microentrepreneurs lack the equity, collateral, track records, management experience and credit histories that bankers look for in extending credit. In addition, women, low-income individuals and minorities are often face even greater difficulties obtaining access to credit

While it is often assumed that most business owners obtain capital from banks, the reality is very different. A survey conducted by CEI in 1991 of Maine businesses with between 1 and 9 employees shows that only 37 percent of the respondents obtained start-up capital from a commercial bank and only 48 percent obtained expansion capital from that same source. This is despite the fact that over 78 percent applied for bank financing. The majority of entrepreneurs rely on personal savings for start-up funds and cash flow for expansion financing. A study of women business owners in Maine conducted by CEI in 2001 revealed that the percentage of women business owners obtaining start-up capital from banks is actually declining. The more recently a business started, the less likely it was to obtain bank financing.

For people with limited resources, the inability to access external sources of capital stifles their ability to start and grow their businesses. The Microloan Program working through intermediaries like CEI responds to this "capital gap" and reaches into a segment of the economy that is overlooked by conventional lenders and traditional economic development strategies. Microenterprise is a business sector that is dynamic and frequently innovative and has demonstrated its potential to generate income and employment for individuals and communities.

However, credit by itself is not sufficient for microbusiness success. The majority of microentrepreneurs are first time business owners without business experience or management expertise. Technical assistance is an important vehicle to help develop the critical skills that can make the difference between business success and failure. Typically, microentrepreneurs require assistance in areas such as business planning, financial management, recordkeeping, cash flow projections, marketing, hiring and personnel issues, regulatory issues, and financing. Yet access to technical assistance can be as problematic as access to credit for many microbusinesses.

According to CEI's survey, nearly half of the business owners sought advice prior to start-up and approximately 75 percent continue to seek advice for ongoing operations. It is not surprising that resources, such as the Small Business Development Centers and the Service Corps of Retired Executives, are strained and that businesses can wait 4-6 weeks to meet with a business counselor. Seventy-percent of the respondents to a 1995

survey of microenterprise organizations in Maine indicated that the demand for technical assistance exceeded their capacity to respond.

Availability, however, is not the only issue. To be effective, technical assistance must be delivered in a manner that responds to the needs of the owner and is appropriate to the scale and type of enterprise. Approximately 30 percent of the respondents to CEI's survey reported that they had difficulty in obtaining good advice. Among the reasons cited were that service providers did not understand their businesses and were not empathetic. Microbusinesses do not match the profile of the businesses targeted by traditional business assistance resources, whose expertise is often based on experience with existing, manufacturing, fast growing, job generating small businesses. In addition, providing technical assistance to microenterprises tends to be labor intensive, and the needs of individual businesses can exhaust the capacity of traditional resources to respond. Linking the provision of technical assistance to organizations with specific expertise in microenterprise development ensures that the assistance will fit the scale of operations, match the skill level of the owner, acknowledge the impact of the issues of race, gender, transfer payments and resource limitations on business development, and be available on an on-going basis.

Upfront business assistance is essential for the vast majority of microenterprises who need support in the development of business plans and applications for financing. Good business planning can minimize some of the difficulties associated with business start-up, but even the best start-up assistance cannot prepare entrepreneurs for all the contingencies they are likely to encounter as their businesses develop. The availability of technical assistance prior to financing, as well as after credit has been extended, is critical to successful microenterprise development.

By coordinating the provision of technical assistance with the availability of financing and delivering both services through a single intermediary, the Microloan Program responds to the needs of microenterprises for technical as well as financial support. By ensuring the availability of long-term technical assistance, the Program enables intermediaries to develop long-term relationships with their customers and to provide the consistent, tailored support that reduces business risk and enhances business productivity.

Over its 10-year history, the SBA Microloan Program has demonstrated how the combination of lending and technical assistance can have a positive impact on the success rate of micro-businesses receiving financing through local lending intermediaries. The low loss rates experienced by SBA microlending intermediaries attests to the efficacy of professionally delivered TA in helping emerging businesses to succeed. Under this program CEI's loss rate has been under 5%.

Role of the Program in Relation to the Field

The implementation and development of the SBA Microloan Program has paralleled and contributed to the growth of the field of microenterprise development. The 2002

Directory of U.S. Microenterprise Programs published by the Aspen Institute in collaboration with the Association for Enterprise Opportunity profiles 650 programs in 50 states, which assisted 90,145 non-borrowers and 9,800 borrowers in 2000. Cumulatively, these programs have provided serves to 540,852 participants and $213,879,591 in loans to 34,472 borrowers. The growth of the SBA Microloan Program has helped to stimulate and support the growth in the field.

Recommendations for Program Development

CEI was part of the initial discussions that resulted in the creation of the Microloan Demonstration Program and has continued working with the SBA and Congress since 1991 to strengthen and sustain the program.

The following recommendations are based on CEI's experience as a practitioner and from discussions with other intermediaries across the country.

1. Increased flexibility in the use of technical assistance funds

CEI supports the Administration's position that would give intermediaries greater flexibility in determining how to use technical assistance funds. As mentioned, businesses have individualized technical assistance needs and intermediaries need the flexibility to provide sufficient assistance both before and after an entrpreneur secures a loan. Intermediaries are selected based on their experience and expertise in responding to the needs of businesses and entrepreneurs and we feel intermediaries need the latitude to work with entrepreneurs as they see the needs arise.

2. Eliminate State Funding Restrictions

It is CEI's understanding that there are still restrictions on the levels of funding available to individual states. While previous legislation made progress in loosening these restrictions, we remain concerned about the impact of a state funding formula as the program grows and the demand for loan funds continues to grow. Areas of high demand and high capacity could be severely constrained. Therefore, we would encourage the elimination of the state funding formula and allowing the SBA to provide loan funds to intermediaries that can demonstrate the demand for funds and the capacity to make additional loans.

3. Uniform Interest Rate

CEI recommends an across the board interest rate for all loans to intermediaries to replace the current system which ties the cost of SBA loans to the 5-year Treasury Bill rate discounted by 1.25 percentage points for regular intermediaries and by 2 percentage points for specialized intermediaries whose loans average less than $10,000.

Many intermediaries have multiple loans from the SBA; each loan has a different interest rate. While interest rates have dropped in recent years, intermediaries are locked

into a range of rates for their loans. While not prohibited by statute, the SBA does not allow intermediaries to refinance at a lower interest rate unless the intermediary is in trouble. Refinancing is not an option for intermediaries who want to consolidate their loans and refinance at the current market rate.

A uniform interest rate would simplify administration of the program for both intermediaries and the SBA, allowing for one set of accounts and reporting. As well, it would encourage intermediaries to have more uniform interest rates as lenders if the cost of SBA funds was the same to all intermediaries.

CEI's rates on these loans range from 3.875% to 6.25% with the most recent rates quoted at 1.25%. This disparity requires us to charge quite different rates form customer to customer, creating some confusion in the market place. Having a more uniform rate structure would help eliminate some of the confusion.

4. Eligibility for participation in the Microloan Program

CEI supports increased flexibility in setting eligibility requirements for program participation and generally supports the Administration's proposal to take staff experience into account rather than looking simply at organizational experience when an organization is applying to be an SBA microlending intermediary. CEI would, however, urge the SBA continue to take into account organizational capacity to effectively manage the program when considering accepting new intermediaries into the program.

5. Funding Levels

Despite the fact that the Microloan Program has clearly met the needs of an underserved market and the fact that intermediaries have demonstrated their capacity to deliver the program in a sound and reasonable manner, the program continues to be underfunded leaving the SBA unable to respond adequately to the demand for funds from existing intermediaries. At the same time, the SBA has continued to bring new intermediaries into the program.

It is particularly important that there be an appropriate balance between the amount of technical assistance money and the loan funds that are available. Inadequate funding and increased demand have resulted in a shortfall in technical assistance funds, which has in turn constrained many intermediaries' ability to access new loan funds. In FY 2002, the SBA ran out of technical assistance funds in late spring, effectively hampering the flow of loan funds to the field.

To illustrate the impact that the funding shortfall has had on our ability to deliver the program, one has only to look at CEI's lending track record. CEI made 43 SBA Microloans in FY2001. The number declined to 34 in FY2002, when CEI ran out of loan money part way through the year. CEI submitted a request for additional loan funds in

June 2002 and is still waiting. Without funds, CEI has been unable to make any SBA Microloans in FY2003.

In addition, given the shortage of technical assistance funds, intermediaries are asked to take on new loans with little or no additional technical assistance funds. Intermediaries who take on new loans without additional technical assistance funds will have their loan request processed first. CEI has agreed with great reluctance to do this because of its desire to obtain the capital needed to deliver the program but we are concerned about setting a precedent that we do not need the technical assistance funds – we are merely looking to address the needs of our borrowers and taking advantage of the SBA resources that are available.

CEI encourages Congress to provide appropriations that are adequate to support the existing intermediaries and to support the addition of new intermediaries in order to ensure that the program is delivered to currently underserved markets

Intermediary Lending Program Pilot Recomendation

Madam Chair, I would like to switch gears slightly and take advantage of this opportunity to participate in this roundtable discussion on credit programs to discuss another credit gap faced by small businesses that we feel CEI and other community based intermediaries could address if resources were made available.

We share your goal, and the goal of the SBA, in ensuring that small businesses have access to the capital and assistance that they need to succeed. In many cases, we feel that community based intermediary lenders, like CEI play and important role in providing that financing and technical support to businesses – sometimes in conjunction with a financial institution.

We see a need for larger scale, longer-term, fixed rate financing to meet the credit needs of growing businesses particularly the working capital needs of these business as they transition past the start-up phase of operation. The challenge is to identify source of financing for businesses needing between $35,000 and $200,000. Even though these businesses have developed a track record, they are still often unable to secure conventional financing – In some cases they might lack the collateral required by banks or have credit needs that fall below the threshold set by conventional lenders.

These are not businesses that can be served through other existing SBA loan programs like the 504 or the 7a guarantee for a variety of reason.

The 504 Program can only be used in very limited circumstances for financing fixed inventory purchases, or other costs associated with establishing or expanding a small business. In addition, the SBA 504 loans will only finance up to 40 percent of the total project cost; another lender needs to furnish 50 percent while the business or its owner typically put in 10 percent. Loans of less than $300,000 are typically not supported by the 504 Program because the transaction costs are too high for the lender to justify lending at

this amount. During the past 10 years CEI has packaged over $31 million in SBA 504 debentures to 104 borrowers. Our average debenture size is $301,000. Most debentures below $200,000 (i.e. total transaction of $500,000) are not practical due to the costs associated with the program. The 7a Program is also not an option for most of these businesses. While we appreciate that there is an effort to encourage 7a lenders to make smaller loans, the transaction costs associated with a 7a loan work against a bank making many loans under $100,000. While the 7a Program has greater flexibility than the 504 Program in the types of business activities it can finance, the underwriting criteria of 7a lenders would eliminate many emerging small and medium sized businesses with insufficient cash flow and collateral.

While the SBA has programs to support the financing needs of very small businesses and the financing needs of larger businesses, we suggest that there is a gap in services for emerging small businesses seeking between $35,000 and $200,000. While these are not the small businesses that need the intensive technical assistance that microbusinesses require they are often the type of businesses that come to CEI, often through the referral of a financial institution, in need of financing and often the type of business expertise and support that an intermediary like CEI can provide. We recommend that a pilot program be established to allow non-profit, community based lending intermediaries, like CEI, to address this lending gap.

CEI has funds from the Department of Agriculture's (USDAs) Intermediary Relending Program (IRP) that enable us to address the financing needs of rural businesses operating in communities of 25,000 or less. This program has been an important tool that has enabled us to reach small and medium sized businesses in our service area and provide financing often with the participation of a bank lender.

To date, CEI has borrowed $5.75 million in IRP funds from USDA and used those funds to originate $ 8.9 million in loans to 109 businesses in the area. The funds have lead to the creation/retention of 3700 jobs in the state.

CEI's IRP loans range from $55,000 to $150,000 with the average loan request being $85,000. While the IRP has been an incredible resource for some of our businesses – we are limited to communities of 25,000 or less and cannot make this financing available to businesses in Augusta, Portland, Lewiston/Auburn or Bangor. We would like to see the SBA making this type of financing available to businesses through intermediaries like CEI that have a proven track record and can reach businesses that have capital needs that do not match up with existing program guidelines.

We recommend that the Committee authorize an Intermediary Relending Program (IRP) pilot to provide community based lending intermediaries, like CEI, with 1%, 30-year loans to capitalize a small business loan fund to provide credit to businesses needing between $35,000 and $200,000 in financing.

Under this pilot, we suggest that the SBA be authorized to select up to 30 IRP lenders, on a competitive basis, to operate IRP loan funds. Non-profit community

development organizations, with a demonstrated track record of working with small businesses and operating loan funds would be eligible to apply And compete for funding and Selected intermediaries would receive 1 percent, 30-year loans from the SBA to capitalize an IRP loan fund targeted to small businesses with capital needs of between $35,000 and $200,000.

Selected IRP lenders would be expected to cover all administrative costs and any technical assistance cost associated with the lending on the interest rate spread between the SBA loan and loans to businesses.

I appreciate the opportunity to present this suggestion to the committee and would be happy to answer any questions that you might have or provide additional information on the proposal.

Alan B. Corbet
Executive Director
Growth Opportunity Connection, Inc.
Kansas City, Missouri

April 30, 2003

U.S. Senate Small Business Committee
Washington D.C.
Testimony on the
U.S. Small Business Administration's Microloan Program

Thank you Madam Chair and members of the Committee for the opportunity to speak before this committee. Previously, I was Chairman of the National Association of SBA Microloan Intermediaries (NASMI). As well, I also serve as the Executive Director of Growth Opportunity (GO) Connection in Kansas City, Missouri where we operate as a SBA Microloan Intermediary lender and SBA the Women's Business Center.

I have over 22 years in the banking and finance industry with the last six years developing and assisting in small business development, job creation, access to markets, and entrepreneurship training. Today, I am here to add support to the funding needs of the SBA Microloan program. We must receive the funding levels necessary to support this program. We are requesting $25 million in technical assistance grants and $25 million to be allocated to the loan funds for fiscal year 2004. The President's budget has only suggested $15 million for technical assistance grants

I want to speak directly to you about the technical assistance grants. For the past two years, the approved budgets have reduced the technical assistance grants to the Intermediaries. If this continues, the SBA Microloan Intermediaries will suffer and eventually go out of business.

This is not just about non-profit Intermediaries going away. They currently owe the federal government approximately $96 million. If they are not in existence,

this amount represents a potential loss to the federal government. The only way to protect that from happening is to provide the technical assistance or borrower support to the micro borrowers we have helped put in business. We would not be making these loans without the assistance we provide. These are high-risk businesses (in fact they are non bankable), and the reason that most of them survive is the dedicated one-on-one business counseling that we provide.

The SBA guidelines provide that grants will be made to Intermediaries up to 25% of their borrowings from SBA. This year (fiscal year 2003) we are only receiving 15% For fiscal year 2002, we received 15%, and 25% was received in Fiscal year 2001. Based on the suggested TA grants in this year's President's budget our grant will only be approximately 11% for FY 2004. This is an extremely critical reduction in the funds we need to mentor and assist these high risk businesses that the SBA has encouraged us to help.

If funding levels proposed in the President's budget is enacted the future of the Microloan program is in jeopardy.

A chart is attached that further explains how the technical assistance funding is allocated.

Over the past 10 years, this program has been responsible for creating and retaining over 55,000 jobs. We must receive the necessary funding of $25 million in TA grants and $25 million for new loans in order to maintain the existence of this program and to minimize the risk of the $100 investment the federal government has placed in our hands.

Thank you.

Grant Amounts of SBA
Microloan Program
to fund Borrower Support Activities

SBA Microloan Program
Projections - April 29, 2003

	(millions)			TA Grant calculation to Intermediaries 15%	20%	25%
FYE 2002 SBA Loans Receivable to Intermediaries	$ 95.6	actual				
Principal Repayment (10%)	$ 9.6	est.				
News Loans	$ 25.0	est.				
FYE 2003 SBA Loans Receivable to Intermediaries	**$ 111.0**	est.				
Principal Repayment (10%)	$ 11.1	est.				
News Loans	$ 25.0	est.				
				(millions)	(millions)	(millions)
FYE 2004 SBA Loans Receivable to Intermediaries	$ 124.9	est.	TA	**$ 16.66**	$ 22.21	$ 27.76
Principal Repayment (10%)	$ 12.5	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 3.75	$ 5.00	$ 6.25
			FY04 Grants	**$ 22.61**	$ 29.41	$ 37.01
FYE 2005 SBA Loans Receivable to Intermediaries	$ 142.4	est.	TA	$ 18.74	$ 24.99	$ 31.23
Principal Repayment (10%)	$ 14.2	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 3.75	$ 5.00	$ 6.25
			FY05 Grants	$ 24.69	$ 32.19	$ 40.48
FYE 2006 SBA Loans Receivable to Intermediaries	$ 158.2	est.	TA	$ 21.37	$ 28.49	$ 35.61
Principal Repayment (10%)	$ 15.8	est.	NTAP'	$ 2.20	$ 2.20	$ 3.00
News Loans	$ 30.0	est.	TA-new loans	$ 4.50	$ 6.00	$ 7.50
			FY06 Grants	$ 28.07	$ 36.69	$ 46.11
			TA	$ 23.73	$ 31.64	$ 39.55
			NTAP'	$ 2.20	$ 2.50	$ 3.00
			TA-new loans	$ 4.50	$ 6.00	$ 7.50
			FY06 Grants	$ 30.43	$ 40.14	$ 50.05

Note: TA = Technical Assistance
NTAP = Non Lending Technical Assistance

The President's Budget suggests $15 million for TA. This means Intermediaries will only receive approximately 11% This level of funding to the Intermediaries will threaten the Intermediaries survival. Eventually, Intermediaries will go out of business. This puts the Intermediaries Notes Receivable payable to the federal government at risk.

April 30, 2003

The Honorable Olympia J. Snowe
Chair
Committee on Small Business and Entrepreneurship
United States Senate
Washington, D.C. 20510

The Honorable John F. Kerry
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate
Washington, D.C. 20510

Dear Senator Snowe and Senator Kerry:

Thank you for the opportunity to participate in your roundtable discussion of April 30, 2003, focusing on reauthorization of the U.S. Small Business Administration's credit programs. JPMorgan Chase Bank, through its wholly owned subsidiary Colson Services Corp., plays an active role in the administration of the Section 7(a) General Business Loan secondary market program. Given SBA's successful efforts to promote a liquid and efficient secondary market for the 7(a) program, we believe this program should serve as a model public-private partnership for other Federal credit agencies interested in generating additional secondary market activity for their Government-guaranteed loans.

The following information is intended to provide background on loan asset securitization and insights into the operation of the 7(a) secondary market program.

Securitization

Many lenders, whether they extend private or Government-backed credit, seek liquidity through the transfer of loans to third party purchasers. This transfer process is known as a secondary market transaction, wherein a purchaser of a loan receives the monthly proceeds as a borrower repays the loan (rather than those payments being retained by the initial lender). Loans may be sold individually but they are increasingly grouped and sold as a single pool. This process allows an investor to purchase an interest in the pool rather than being forced to conduct multiple transactions to buy individual loans. The pooling mechanism allows investors to better manage and diversify risk and ensures an efficient transfer of loans and informed pricing by rating agencies or other experts. This process of loan pooling and sales is known as securitization. Its primary benefit is that it provides a method for lenders to immediately achieve value for loans made and then re-circulate loan sale proceeds into additional lending.

Three principal challenges typically exist in establishing a secondary market. First, investors require reliable historical information about the loans and their performance. Second, standardization and homogeneous loan characteristics are important factors in the buying decision. Third, once purchased, the transfer of the

JPMorgan Chase Bank, 800 Connecticut Avenue NW, Floor 9, Washington, DC 20006
Telephone: 202-533-2128 Facsimile: 202-533-2125

borrower's monthly payment to the investor must be efficient and not inconvenient to either the borrower or the investor.

A Fiscal and Transfer Agent (FTA) is a central agent entity responsible for ensuring loan repayments from borrowers to lenders flow through to investors. The FTA provides services to allow investor payments (for loans purchased) to be properly remitted to lenders. The FTA also allows the borrower to continue to make payments to only one entity, regardless of how the loan may have been pooled or transferred to secondary market investors. FTAs for Government programs may be paid directly by an agency, particularly during the start up phase. Once a market is operational, the FTA's services (as is the case for SBA) can be structured at no cost to the Government if lenders and investors remit a fee to the FTA for each secondary market transfer rather than having the FTA compensated with appropriated funds from the agency.

By undertaking this flow of funds and record keeping role, the FTA also is in an ideal position to remit information about the program to the sponsoring agency. Such information may include status reports on loans the FTA touches -- either because the loans were transferred to the secondary market or the FTA may be collecting fees and status information on all loans. Because the loan information reporting channels can be designed to regularly involve the FTA, the agent can also become the information gathering point for programmatic, demographic, or other data the Government desires to collect.

Securitization of SBA 7(a) Loans

Enactment of the Small Business Secondary Market Improvement Act of 1984 allowed for the establishment of a secondary market for Section 7(a) loans guaranteed by SBA with the objective of increasing bank liquidity and increasing funds available for small business lending. The Act called for a Fiscal and Transfer Agent to provide central registration and servicing of loans sold. SBA subsequently hired Colson Services Corp. to carry out those responsibilities. As SBA's exclusive FTA, Colson processes over 57,000 monthly loan payment remittances received from lenders nationwide which are due to secondary market investors and other designated parties. Accordingly, Colson interacts with thousands of lending institutions including money-center banks, commercial banks, savings and loans associations, savings banks, and non-depositary lenders.

In 1986, a Master Reserve Fund was set up to guarantee timely payment on the pools. It was also established to meet a Congressional mandate that the operation of the secondary market be self-sustaining and not require an appropriation for any costs. Pools are formed from the SBA-guaranteed portion of loans. The agency guarantees both principal and interest through the 7(a) program and guarantees timely payment on pools through its secondary market program. A pool must include at least four loans and the minimum dollar amount for each pool is $1 million. The maturity of the loan with the shortest maturity can be no less than 70 percent of the loan with the longest maturity. The loans in a particular pool pay the same rate of interest as the pool, and may be either fixed or floating (floating rate indexed to Prime plus/minus a spread). Both the loans and the pools pay principal and interest payments monthly.

JPMorgan Chase Bank, 800 Connecticut Avenue NW, Floor 9, Washington, DC 20006
Telephone: 202-533-2128 Facsimile: 202-533-2125

Under its contract with SBA, Colson collects both loan status information and fees paid by lenders that are used to offset 7(a) subsidy costs. On average, Colson receives over 80,000 fee payments and loan status information reports each month for over 200,000 loans on an SBA-standardized form (submitted either in hard-copy or electronically). In turn, Colson regularly exchanges this loan status and fee data with SBA's databases.

Colson also reviews individual SBA certificates to determine eligibility for pooling. The 1984 Act supported pooling with the intent of providing increased efficiency, better liquidity, and a more established and improved SBA product in the secondary market. Accordingly, such improvements enabled lenders and broker/dealers to structure securitized SBA loans into attractive investment instruments for institutional investors. Pools of similarly situated loans are created (albeit diversified geographically and by amount, lender, and industry sector) that provide a timely guarantee of monthly principal and interest to investors.

SBA's appointment of Colson as FTA along with legislative, regulatory, and market developments since the 1984 Act has served to further recognize, expand, and improve the efficiency and liquidity of the secondary market in SBA loans.[1] Since 1986, the 7(a) program has seen dramatic growth in loan volume and improvements in reporting compliance, lender training, customer service, and communications.

To support its myriad loan administration services, Colson boasts an extensive operational and systems infrastructure, which continues to be refined, to accommodate the changing requirements of SBA's loan portfolio. Colson's proven processes are further reflected in its comprehensive training curriculum where SBA field offices, lenders, and other program participants are trained and/or contacted regularly to keep them abreast of new program rules and policies.

SBA's FTA mechanism is a model blueprint to support secondary market transactions and represents a highly effective public-private partnership. Since it stands as the administrative hub of an important secondary market loan program, the FTA streamlines payment transactions and systematizes information flow to and from program participants. Specifically, it affords SBA the opportunity to:

- Leverage a proven mechanism and efficient system to promote SBA's secondary market program;
- Access and compile comprehensive portfolio statistics from a secure, centralized database;
- Effectively communicate with all program participants; and
- Obtain complete, standardized information on the secondary market program and loan status reporting.

To the extent the Committee is considering any changes to the secondary market program, we suggest that any improvements be geared toward improving liquidity for the

[1] Statement of The Bond Market Association, 3/1/2000

7(a) product in the marketplace and making the product more efficient (e.g., less paper and shift to web-based processes). As with the secondary market for home mortgages, taking steps to improve liquidity and efficiency of the 7(a) marketplace could attract new sources and larger amounts of capital to the lending market, resulting in a greater volume of business loans at lower interest rates. We look forward to working with the Committee along with SBA and its constituent lenders to achieve that goal.

Thank you for the opportunity to comment on this matter.

Sincerely,

Douglas A. Criscitello
Vice President

JPMorgan Chase Bank, 800 Connecticut Avenue NW, Floor 9, Washington, DC 20006
Telephone: 202-533-2128 Facsimile: 202-533-2125

United States General Accounting Office

GAO

Testimony
Before the Committee on Small Business and Entrepreneurship, U.S. Senate

For Release on Delivery
Expected at 9:30 a.m. EDT
Wednesday, April 30, 2003

SMALL BUSINESS ADMINISTRATION

Progress Made but Improvements Needed in Lender Oversight

Statement of Davi M. D'Agostino
Director, Financial Markets and Community Investments

GAO-03-720T

Madam Chair and Members of the Committee:

I am pleased to be here today at this roundtable to discuss the results of our work on the Small Business Administration's (SBA) oversight of its 7(a) loan program lenders, particularly those who participate in the Preferred Lenders Program or PLP. SBA delegates full authority to preferred lenders to make loans without prior SBA approval. In fiscal year 2002, preferred lenders approved 55 percent of the dollar value of all 7(a) loans—about $7 billion. Small businesses are certainly a vital part of the nation's economy. According to SBA, they generate more than half of the nation's gross domestic product and are the principal source of new jobs in the U.S. economy. In turn, SBA's mission is to maintain and strengthen the nation's economy by aiding, counseling, assisting, and protecting the interests of small businesses. Providing small businesses with access to credit is a major avenue through which SBA strives to fulfill its mission. Strong oversight of lenders by SBA is needed to protect SBA from financial risk and to ensure that qualified borrowers get 7(a) loans. SBA has a total portfolio of about $46 billion, including $42 billion in direct and guaranteed small business loans and other guarantees.[1] Because SBA guarantees up to 85 percent of the 7(a) loans made by its lending partners, there is risk to SBA if the loans are not repaid. SBA must ensure that lenders provide loans to borrowers who are eligible and creditworthy to protect the integrity of the 7(a) program.

Our statement today is based on the report we issued December 9, 2002, *Small Business Administration: Progress Made but Improvements Needed in Lender Oversight* (GAO-03-90). The report and our remarks will focus on our evaluation of (1) SBA's 7(a) lender oversight program and (2) SBA's organizational alignment for conducting oversight of preferred lenders and Small Business Lending Companies (SBLC).[2] In addition, we will comment on SBA's latest response to our findings and recommendations.[3] Our overall objective is to provide the Committee with information and perspectives to consider as it moves forward on SBA reauthorization.

[1]As of September 30, 2002.

[2]SBLCs, which make only 7(a) loans, are privately owned and managed, nondepository, lending institutions that are licensed and regulated by SBA but not generally regulated or examined by financial institution regulators.

[3]Hector Barreto, SBA Administrator, letter to The Honorable Susan Collins, Chair, Committee on Government Affairs, U.S. Senate, March 12, 2003.

In analyzing SBA's oversight of its preferred lenders, we defined oversight to include both SBA's reviews of preferred lenders for compliance with SBA rules and regulations and SBA's evaluations of lenders to decide their initial and continued participation in the PLP. We focused our reviews in part to follow up on recommendations made in our June 1998 report, where we found that SBA was doing few reviews of its preferred lenders.[4] We analyzed a sample of review reports and PLP guidance, and review and lending data to the extent that they were available. We also interviewed SBA headquarters and regional staff, PLP lenders, and representatives of the National Association of Government Guaranteed Lenders.

Summary

SBA has made progress in developing its lender oversight program, but there are still areas in need of improvement. While SBA has identified appropriate elements for an effective lender oversight program, it has been slow to change programs and procedures to fully incorporate all of these elements. In addition, financial risk management issues have become more critical for SBA, as its current loan programs focus on partnering with lenders, primarily banks, that make loans guaranteed up to 85 percent by SBA. However, our work showed that

- SBA had not yet consistently incorporated adequate measures of financial risk into the PLP review process or the SBLC examination program.
- The current PLP review process, which SBA uses to ensure compliance with the program mission, rules, and regulations, involves a cursory review of documentation maintained in lenders' loan files rather than a qualitative assessment of borrower creditworthiness or eligibility.
- SBA's standards for borrower eligibility (the "credit elsewhere" requirement) are broad and therefore subject to interpretation.
- SBA had not developed clear enforcement policies for preferred lenders or SBLCs that would specifically describe its response in the event that reviews discover noncompliance or safety and soundness problems.

[4]U.S. General Accounting Office, *Small Business Administration: Few Reviews of Guaranteed Lenders Have Been Conducted*, GAO/GGD-98-85 (Washington, D.C.: June 1998).

- SBA had been slow to finalize and issue SBLC examination reports.[5] In addition, SBA had been slow to respond to recommendations for improving the SBLC examination program.

Without continued improvement to better enable SBA to assess the financial risk posed by 7(a) loans and to ensure that its lending partners are making loans to eligible small businesses, SBA will not have a successful lender oversight program.

Although SBA has listed the oversight of its lending partners as an agency priority, the function does not have the necessary organizational independence or resources to accomplish its goals. In our past work analyzing organizational alignment and workload issues, we have described the importance of (1) tying organizational alignment to a clear and comprehensive mission statement and strategic plan and (2) providing adequate resources to accomplish the mission. However, two different offices—Lender Oversight and Financial Assistance, both of which are in the Office of Capital Access (OCA)—carry out SBA's lender oversight functions (see fig. 1). OCA also promotes and implements SBA's lending programs. This alignment presents a possible conflict because PLP promotion and operations are housed in the same office that assesses lender compliance with SBA safety and soundness and mission requirements. Additionally, split responsibilities within OCA and limited resources have impeded SBA's ability to complete certain oversight responsibilities, which could result in heightened risk to its portfolio or lack of comprehensive awareness of portfolio risk.

Our report made recommendations to improve SBA's oversight of its lenders. Specifically, we recommended that SBA:

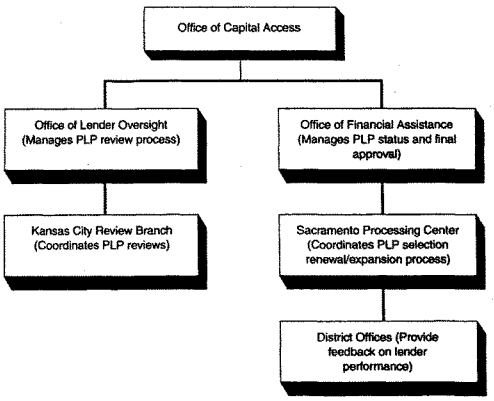
- incorporate strategies into its review process to adequately measure the financial risk lenders' portfolios of guaranteed SBA loans pose to SBA,
- develop specific criteria to apply to the credit elsewhere standard used to determine borrower eligibility,

[5]Since 1999, SBA has had an agreement with the Farm Credit Administration (FCA) to conduct safety and soundness examinations of the SBLCs. FCA is an independent agency within the executive branch; it regulates Farm Credit System institutions. FCA also contracts with other government agencies to provide examination services.

- perform qualitative assessments of lenders' performance and lending decisions,
- clarify its enforcement authority and specify conditions under which it would take enforcement action,
- make the preferred lender program more accessible to large national lenders, and
- better emphasize lender oversight in its organizational alignment to provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight.

SBA essentially disagreed with part or all of our recommendations for improving its assessments of lenders, said that it was "working to address" issues we raised about enforcement and accessibility of the preferred lender program, and disagreed with our recommendation to separate lender oversight functions and responsibilities from preferred lender program management functions.

Figure 1: Preferred Lender Oversight Responsibilities within OCA



Source: GAO analysis of SBA's structure.

Background

The 7(a) loan program, which is authorized by Section 7(a) of the Small Business Act, is SBA's largest business loan program.[6] It is intended to serve small business borrowers who otherwise cannot obtain financing under reasonable terms and conditions from the private sector. In administering the 7(a) program, SBA has evolved from making guaranteed loans directly to depending on lending partners, primarily banks.[7] Under 7(a), SBA provides guarantees of up to 85 percent on loans made by participating lenders.

Within 7(a), there are three classifications of lenders—regular, certified, and preferred. SBA evaluates and grants preferred lender status to 7(a)

[6]15 U.S.C. § 636 (2000).

[7]Other types of financial institutions, such as savings banks, are lending partners. In this statement, we refer to all financial institutions that make 7(a) loans as banks.

lenders after receiving nominations and reviews from its 70 district offices and a regional processing center. Of the three categories, preferred lenders have the most autonomy in that they can make loans without prior SBA review or approval. Most preferred lenders are banks that have their own safety and soundness regulators, such as the Office of the Comptroller of the Currency. Those regulators, however, may not focus on the 7(a) loans that SBA guarantees when they examine the bank. The other preferred lenders, which are SBLCs, have no regulator other than SBA—making SBA oversight more critical. As of August 2002, SBA had over 400 preferred lenders. To give you an idea of this program's scope, in fiscal year 2002, 7(a) loan approvals totaled approximately $12.2 billion, of which preferred lenders approved $6.7 billion. However, preferred lending activity is concentrated in a few larger institutions. Less than 1 percent of 7(a) lenders account for more than 50 percent of 7(a) dollar volume outstanding. According to SBA, most of these lenders are preferred lenders.

Two offices within SBA have primary responsibility for 7(a) lender oversight—the Office of Lender Oversight (OLO) and the Office of Financial Assistance (OFA). OLO is responsible for many oversight functions, such as managing all headquarters and field office activities regarding lender reviews. However, OFA has retained some oversight responsibilities. OFA's current role in lender oversight is to provide final approval of lenders' PLP status. Lenders are granted PLP status in specific SBA districts for a period of 2 years or less. OFA collects information about the lender prepared by the Sacramento Processing Center, with input from one or more of SBA's 70 district offices, and decides whether to renew a lender's PLP status or to grant status in an additional district. OFA may also discontinue a lender's PLP status.

Other lenders participating in the 7(a) program are subject to a different oversight regime. Specifically, SBA divides SBLC program functions between OLO and OFA. OLO is responsible for SBLC on-site examination, and OFA handles day-to-day program management and policymaking. Ultimate responsibility for enforcement of corrective actions rests with OCA. As participants in the 7(a) program, SBLCs are subject to the same review requirements as other 7(a) lenders, and they are also subject to safety and soundness oversight by SBA.

Lender Oversight Is Not Achieving All of Its Goals

SBA has identified goals for its lender oversight program that are consistent with appropriate standards for an oversight program; however, SBA had not yet established a program that is likely to achieve them. Since our last review, SBA had made progress in developing its lender oversight program, but there are still areas in need of improvement if SBA is to develop a successful program. SBA has highlighted risk management in its strategy to modernize the agency; however, PLP reviews are not designed to evaluate financial risk, and the agency has been slow to respond to recommendations made for improving its monitoring and management of financial risk—posing a potential risk to SBA's portfolio. PLP reviews are designed to determine lender compliance with SBA regulations and guidelines, but they do not provide adequate assurance that lenders are sufficiently assessing eligibility and creditworthiness of borrowers.

Although SBA has identified problems with preferred lender and SBLC lending practices, it has not developed clear policies that would describe enforcement responses to specific conditions. Thus, it is not clear what actions SBA would take to ensure that preferred lenders or SBLCs address lending program weaknesses. Although the process for certifying lenders for PLP status—another means by which SBA oversees lenders—has become better defined and more objective, some lenders told us they continue to experience confusing and inconsistent procedures during this process due to varying recommendations from field offices.

SBA Has Made Progress in Developing Its Lender Oversight Function

Since our June 1998 report, SBA has responded to a number of recommendations for improving lender oversight by developing guidance, establishing OLO, and doing more reviews. SBA developed "Standard Operating Procedures" (SOP) for oversight of SBA's lending partners and the "Loan Policy and Program Oversight Guide for Lender Reviews" in October 1999.

SBA established OLO in fiscal year 1999 to coordinate and centralize lender review processes for PLP and SBLC oversight. OLO created a "Reviewer Guide" for personnel engaged in PLP reviews and does training for all SBA staff involved in conducting preferred lender reviews. OLO officials said that to effectively oversee and monitor SBA lenders, they also evaluate lender-generated risk to the SBA portfolio, work with SBA program offices to manage PLP oversight operations, and plan to conduct regular and systematic portfolio analysis using a new loan monitoring system. Additionally, to minimize the number of visits SBLCs receive during a year, OLO combined PLP reviews with SBLC examinations performed by FCA.

In another effort to improve the lender review process, SBA developed an automated, 105-item checklist that is designed to make its analysis more objective. The questionnaire addresses lender organizational structure, policies, and controls, but the answers are provided in a "yes-no" format and generally refer to the presence or absence of specific documents. SBA noted that the format makes assessments of lenders more consistent and objective. However, we note that without a more substantive method of evaluating lender performance, this approach does not provide a meaningful assessment.

SBA also has increased the number of PLP reviews performed. In June 1998, we reported that SBA had not reviewed 96 percent of 7(a) lenders, including preferred lenders, in the districts we visited. SBA reviewed 385 reviews of 449 preferred lenders in its 2001– 2002 review year.[8]

SBA's Lender Oversight Does Not Adequately Focus on Financial Risk

While elements of SBA's oversight program touch on the financial risk posed by preferred lenders, including SBLCs, weaknesses in the program limit SBA's ability to focus on, and respond to, current and future financial risk to their portfolio. Neither the PLP review process nor SBA's off-site monitoring efforts adequately focus on the financial risk posed by preferred and other lenders to SBA. SBA oversight of SBLCs is charged with monitoring how SBLCs administer their credit programs, identifying potential problems, and keeping SBA losses to an acceptable level. However, SBA's progress in reporting examination results in a timely manner and implementing other program improvements limits the effectiveness of SBA's SBLC oversight.

SBA officials stated that PLP reviews are strict compliance reviews that are not designed to measure the lenders' financial risk. Our review and that of SBA's Inspector General (IG) confirmed this. The PLP review serves as SBA's primary internal control mechanism to determine whether preferred lenders are processing, servicing, and liquidating loans according to SBA standards and whether such lenders should participate in the programs. While the review has questions that touch on the financial risk of a given loan, review staff are not required to answer them; and SBA guidance explicitly states that the answers to the questions are for

[8]SBA's review year runs from April 1 to March 31. SBA officials explained that the initial date of its contract with the vendor that conducts PLP reviews began on April 1, and they have since used this as the beginning of their review year.

research purposes only and are not to be considered in making any determinations about the lender. By not including an assessment of the financial risk posed by individual lenders during PLP reviews, SBA is missing an opportunity to gather information that could help predict PLP lenders' future performance, thereby better preparing SBA to manage the risk to its portfolio. The SBA IG also suggested that financial risk and lender-based risk should be considered as part of a comprehensive oversight program.[9]

SBA's off-site monitoring efforts do not adequately assess the financial risk posed by PLP and other lenders. SBA currently uses loan performance benchmarking and portfolio analysis to serve as its primary tools for off-site monitoring. While SBA officials stated that loan performance benchmarks are based on financial risk and serve as a measure to address a lender's potential risk to the SBA portfolio, we found that the benchmarks were not consistently used for this purpose.[10] In addition, we found that OLO does not perform routine analysis of SBA's portfolio to assess financial risk. At the time of our review, staff produced ad-hoc reports to analyze aggregate lending data to look for trends and to try to anticipate risk.

SBA Has Not Eliminated Weaknesses in SBLC Oversight That Pose a Threat to the SBA Portfolio

Currently, FCA staff responsible for SBLC safety and soundness examinations also perform PLP reviews at SBLCs—these reviews are the same ones that SBA contractors perform at preferred lenders and employ the same review checklist.[11] Upon the completion of its examinations, FCA provides a draft report to SBA for comment, incorporates any changes, and then provides a final report to SBA, which, in turn, issues a final report to the SBLC.

[9]The SBA Inspector General defines financial risk as the composite risk posed by loans and guarantees actually booked to SBA's portfolio and how they perform over time, and defines lender-based risk as the potential financial injury due to the lender's failure to perform its role properly. U.S. Small Business Administration, Office of Inspector General, *Audit Report PLP Oversight Process*, Report Number 1-19, (Washington, D.C.: September 27, 2001).

[10]The five benchmarks are ratios for currency, delinquency, default, liquidation, and loss. Each is defined in SBA's SOP.

[11]FCA conducts broad-based examinations and evaluates each SBLC's capital adequacy, asset quality, management, earnings, and liquidity. The examinations are similar to safety and soundness examinations performed by bank and government-sponsored enterprise regulators.

SBA has not eliminated weaknesses in SBLC oversight, which were cited by us and the SBA IG. We, and the SBA IG, found that final SBLC examination reports were not issued in a timely manner. SBA's IG reported that final reports for fiscal year 2001 SBLC examinations were not issued until February 2002, 10 months after OLO received the first draft report from FCA.[12] Our work confirmed these findings. We found that OLO does not maintain standards for the timely issuance of examination reports. However, OLO has recently developed draft customer service goals calling for SBLC examination reports to be finalized within 90 days of receipt of a draft report from FCA. However, as of August 2002, none of the examination reports from fiscal year 2002 had been issued. According to the IG, because of the delays in finalizing the reports and SBA's policy to delay any necessary enforcement actions until final reports are issued, two SBLCs were allowed to continue operating in an unsafe and unsound manner, despite early identification of material weaknesses during fiscal year 2001 examinations. The effectiveness of any examination program is measured, to a large degree, on its ability to identify and promptly remedy unsafe and unsound conditions. By delaying reporting and remedial action, SBA has significantly limited the effectiveness of its SBLC oversight program.

SBA has been slow to implement recommendations from FCA for improving the SBLC examination program. In addition to examining SBLCs, FCA was asked by SBA to provide recommendations for changes in the SBLC program. Each year FCA provides its views in a comprehensive report. FCA's September 1999 report made 15 recommendations, 12 of which SBA agreed to implement.[13] We reviewed the reports for fiscal years 2000 and 2001, in which FCA made additional recommendations with which SBA agreed. Yet, the 2001 report still lists 8 recommendations from the 1999 report and 2 from the 2000 report. SBA officials explained that limited resources have contributed to the delay in implementation of many of these recommendations.

[12]U.S. Small Business Administration, Office of Inspector General, *Improvements Are Needed in the Small Business Lending Company Oversight Process*, Report No. 2-12 (Washington, D.C.: March 20, 2002).

[13]We listed the 15 recommendations in our November 2000 report. See U.S. General Accounting office, *Small Business Administration: Actions Needed to Strengthen Small Business Lending Company Oversight*, GAO-01-192 (Washington, D.C.: November 2000).

PLP Reviews Do Not Provide Adequate Assurance That Lenders Are Sufficiently Assessing Eligibility and Creditworthiness

Assessing whether a borrower is eligible for 7(a) assistance is difficult because the requirements are broad and variable, making a qualitative assessment of a lender's decision by a trained reviewer all the more important. SBA regulations require a lender to attest to the borrower's demonstrated need for credit by determining that the desired credit is unavailable to the borrower on reasonable terms and conditions from nonfederal sources without SBA assistance.[14] These "credit elsewhere" provisions are particularly difficult to assess and must be determined prior to assessing other credit factors.[15] SBA guidance also requires preferred lenders to certify that credit is not otherwise available and to retain the explanation in the borrower file.[16] SBA does provide guidance on factors that may contribute to a borrower being unable to receive credit elsewhere. Factors that lenders should consider include the following:

- The business requires a loan with a longer maturity than the lender's policy permits;
- The requested loan exceeds either the lender's legal limit or policy limit, regarding amounts loaned to one customer;
- The lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market;
- The collateral does not meet the lender's policy requirements because of its uniqueness or low value;
- The lender's policy normally does not allow loans to new ventures or businesses in the applicant's industry; and
- Any other factors relating to the credit that in the lender's opinion cannot be overcome except by receiving a guaranty.

Based on these criteria, the credit elsewhere test could always be satisfied by structuring an SBA guaranteed loan so that its terms and conditions differ from those available on the commercial market. As a result, these

[14]The SBA regulations do not further define "reasonable terms and conditions." See also 13 C.F.R. Section 120.101.

[15]Section 7(a) of the Small Business Act states that "no financial assistance shall be extended if the applicant can obtain credit elsewhere." 15 U.S.C. Section 636(a).

[16]SBA SOP 50-10(4)(E).

loans could be made available to businesses that could obtain credit elsewhere on reasonable market terms and conditions, although not the same terms and conditions offered with the SBA guarantee.

SBA officials stated that the credit elsewhere requirements are designed to be broad so as to not limit a lender's discretion and allow flexibility, depending upon geographic region, economic conditions, and type of business. For example, SBA officials said that when credit is more readily available, businesses that require SBA assistance might be held to a different standard, thereby making it more difficult to obtain the SBA guarantee than when credit is tighter. Nonetheless, the flexibility that lenders have along with the difficulty in assessing lenders' credit elsewhere decisions further support the need for developing specific criteria for a credit elsewhere standard. These changes would facilitate a more qualitative assessment of eligibility decisions made by preferred lenders.

Moreover, because it is a cursory review of documents in the file, the PLP review also does not qualitatively assess a lender's credit decision. Preferred lenders are required to perform a thorough and complete credit analysis of the borrower and establish repayment terms on the loan in the form of a credit memorandum. SBA guidance requires, at a minimum, discussion in the credit memorandum of a borrower's capitalization or proof that the borrower will have adequate capital for operations and repayment, as well as capable management ability.[17] SBA officials said that lender review staff focus on the lender's process for making credit decisions rather than the lender's decision. SBA officials said that it is unlikely that the review would result in a determination that the loan should not have been made. An SBA official stated that review staff would not perform an in-depth financial analysis to assess the lender's credit decision and that a lender's process would only be questioned in the case of missing documentation. For example, review staff would cite a lender if it did not document the borrower's repayment ability.

Some lenders we interviewed criticized the lack of technical expertise of contract review staff. The lenders stated that review staff was unable to provide additional insight into material compliance issues during the review because of a lack of technical knowledge of the underwriting process and requirements. For example, one lender said he was cited for

[17]SBA SOP 50-10(4).

not signing a credit elsewhere statement, but the reviewer did not evaluate a financial statement in the file substantiating the credit elsewhere assessment.

To improve PLP and SBLC oversight, we recommended that SBA incorporate strategies into its review process to adequately measure the financial risk lenders pose to SBA, develop specific criteria to apply to the credit elsewhere standard, and perform qualitative assessments of lender performance and lending decisions. SBA stated that it believes the existing statutes, regulations, policies, and procedures provide sufficient guidance to lenders. These are the same sources we analyzed and found to be broad, making a qualitative assessment of a lender's decisions difficult. SBA has responded that it does measure financial risk of SBLCs through the safety and soundness examinations conducted by FCA and that the PLP lender reviews do estimate some degree of financial risk. We had noted both of these measures in our December 9, 2002 report. We also noted that SBA had not acted on suggestions that FCA had made to enhance SBA's oversight of SBLCs. Only 3 of 15 preferred lender review reports that we reviewed provided any evidence of such an assessment. And, we note, SBA's review guidance does not require such a review. Thus, our recommendations remain open.

SBA Has Not Developed Clear Enforcement Policies for Preferred Lenders and SBLCs

SBA has authority to suspend or revoke a lender's PLP status for reasons that include unacceptable loan performance; failure to make enough loans under SBA's expedited procedures; and violations of statutes, regulations, or SBA policies.[18] However, SBA has not developed policies and procedures that describe circumstances under which it will suspend or revoke PLP authority or how it will do so. SBA guidance does not include specific follow-up procedures for PLP lenders that receive poor review ratings, but it does discuss recommended patterns of follow-up. SBA officials said that, in practice, they request action plans to address deficiencies for any ratings of "minimally in compliance" and "not in compliance." In addition, lenders with ratings of not in compliance are to receive follow-up reviews. SBA officials explained that because they want to encourage lenders to participate in PLP, they prefer to work out problems with lenders, and therefore rarely terminate PLP status. And, where a lender persists in noncompliance, SBA will generally allow the status to expire, rather than terminating it. However, without clear

[18] 13 C.F.R. § 120.455 (2002).

enforcement policies, PLP lenders cannot be certain of the consequences of certain ratings and they may not take the oversight program seriously.

In November 2000, we recommended that the SBLC examination program could be strengthened by clarifying SBA's regulatory and enforcement authority regarding SBLCs. Although it has the authority to do so, SBA has yet to develop, through regulation, clear policies and procedures for taking supervisory actions. By not expanding the range of its enforcement actions—which it can do by promulgating regulations—SBA is limited in the actions it can take to remedy unsafe and unsound conditions in SBLCs. SBA regulations only provide for revocation or suspension of an SBLC license for a violation of law, regulation, or any agreement with SBA. Without less drastic measures, SBA has a limited capability to respond to unsatisfactory conditions in an SBLC. Unlike SBA, federal bank and thrift regulators use an array of statutorily defined supervisory actions, short of suspension or revocation of a financial institution's charter or federal deposit insurance, if an institution fails to comply with regulations or is unsafe or unsound.

We recommended that SBA provide, through regulation, clear policies and procedures for taking enforcement actions against preferred lenders and SBLCs in the event of continued noncompliance with SBA's regulations. Most recently, SBA has responded that it does have clear policies and procedures; however, the agency intends to expand upon them. We will continue to followup and monitor SBA's response to this recommendation.

SBA's Process for Administering PLP Status Presents Lenders with Challenges

SBA's preferred lender certification process begins when a district office serving the area in which a lender's office is located nominates the lender for preferred status or when a lender requests a field office to consider it for PLP status. The district will then request performance data regarding the lender from SBA's Sacramento Processing Center. The processing center then provides the district office with data required to fill in part of a worksheet developed for the nomination process. The district office sends the completed worksheet, along with other required information, back to the processing center. The processing center analyzes the nomination and sends it with a recommendation to OFA for final decision.

According to SBA's SOP, in making its decision, OFA considers whether the lender (1) has the required ability to process, close, service, and liquidate loans; (2) has the ability to develop and analyze complete loan packages; and (3) has a satisfactory performance history with SBA. OFA also considers whether the lender shows a substantial commitment to

SBA's "quality lending goals," has the ability to meet the goals, and demonstrates a "spirit of cooperation" with SBA.

OFA and district office staff said that although district offices do not provide final approval of PLP status for lenders in their districts, they generally play an important role and district input is given significant weight. Most of the district office staff we interviewed believed that they had considerable influence on OFA's decision regarding a lender's PLP status.

A PLP lender may request an expansion of the territory in which it can process PLP loans by submitting a request to the Sacramento Processing Center. The processing center will obtain the recommendation of each district office in the area into which the PLP lender would like to expand its PLP operations. The processing center will forward the district recommendations to OFA for a final decision.

Lenders we interviewed had varying experiences in gaining and maintaining their PLP status. While some lenders expressed general satisfaction with the process and their understanding of it, others cited problems. For example, several PLP lenders we interviewed said that they had their PLP status declined in a specific district, although they had already achieved PLP status in other districts. In some instances, lenders said that they did not understand why they had been turned down, in light of their proven performance. These lenders commented that some district offices were not open to working with lenders from outside their districts while others were. In our interviews with district offices, we sometimes heard differing descriptions from district office officials on the level of commitment required of a lender who wished to gain PLP status in their district. Some district officials said that a lender had to maintain a physical presence in the district, while others disagreed. However, all district office officials expressed the need for some regular discussion with a lender to understand the lender's commitment to the district.

Larger lenders, as well as the National Association of Government Guaranteed Lenders (NAGGL), noted the administrative burden of maintaining relationships with many of the 70 district offices to maintain PLP status. The lenders noted that to receive and maintain PLP status in a given district, it is generally necessary to meet at least annually with district office staff to discuss status and plans for future lending. For some large national lenders, this can amount to 40 or more visits per year. In response to this concern, NAGGL has recommended a national PLP status based on a uniform national standard to ease the administrative burdens

on large national lenders that account for the largest volume of PLP lending.

District office officials that we interviewed generally acknowledged that they want to understand a lender's plans for their district before agreeing to endorse a lender that wishes to gain PLP status in their district. District officials explained that PLP status is an important marketing tool for lenders. As advocates for the credit needs of small businesses in their districts, the district office officials see PLP status as a "carrot" to encourage lenders to make a sufficient volume of loans to their district. They suggest that a "national" PLP lender might make a large volume of PLP loans nationwide, but none in their district. The officials reason that without a district-by-district PLP status, district offices would lose an important tool for encouraging lenders to respond to credit needs in their districts.

To hold lenders to a uniform national standard while maintaining individual district office's preferences and reinforcing their relationships with PLP lenders, SBA developed a formula-driven lender evaluation worksheet to facilitate the nomination, expansion, and renewal processes. The worksheet replaces the former procedure that involved written recommendations from district officials; however, it continues to award points based on sometimes subjective criteria, such as the district office's assessment of the lender's SBA marketing and outreach efforts, rather than the formulas in the spreadsheet. Where this is the case, district office staff are required to provide written justification for the points awarded.

SBA has a Lender Liaison program, managed by its Office of Field Operations (OFO), to assist large national lenders in managing relationships with SBA. The program involves the assignment of a single SBA official, generally a district director, to act as a liaison to a large national lender. In the event that a large lender should experience difficulty in managing its PLP status, it would have a single SBA official to call to assist in resolving any problems. OFO staff said that feedback they have received from lenders indicated that they like the program, finding it useful for resolving difficulties. Two of the lenders we interviewed participated in the program, and both expressed satisfaction with it. SBA has designated lender liaisons for 20 PLP lenders and, at the time of our review, intended to expand the program to 50 additional lenders. OLO identified 70 lenders who have PLP status in 6 or more districts and could benefit from the program.

We recommended that SBA continue to explore ways to assist large national lenders to participate in the PLP. SBA has indicated that they are reviewing the issues we identified with regard to large national lenders and considering the best approach to address the issues. We will continue to followup with SBA and monitor its response on this matter.

SBA's Organizational Alignment Does Not Adequately Support SBA's Lender Oversight Functions

In our past work analyzing organizational alignment and workload issues at SBA and other agencies' efforts to improve management and performance, we have described the importance of tying organizational alignment to a clear and comprehensive mission statement and strategic plan. By organizational alignment, we mean the integration of organizational components, activities, core processes, and resources to support efficient and effective achievement of outcomes. For example, we noted how agency operations can be hampered by unclear linkage between an agency's mission and structure, but greatly enhanced when they are tied together.[19] We have identified human capital management challenges in key areas, which include undertaking strategic human capital planning and developing staffs whose size, skills, and deployment meet agency needs.[20] We have also noted the importance of separating safety and soundness regulation and mission evaluation from the function of mission promotion. While SBA's role regarding PLP lenders is slightly different from that of a safety and soundness regulator, two principles still apply to SBA. First, oversight and program evaluation functions should be organizationally separate and maintain an arm's-length relationship from program promotion. And second, in evaluating program compliance, SBA needs to weigh the financial risks to the federal government along with the 7(a) program's mission to provide credit to those who cannot get it elsewhere.

SBA officials have said and written that lender oversight is becoming an increasing priority for SBA; however, the function is not housed in an independent office with the exclusive role of providing lender oversight. OLO was created within OCA in fiscal year 1999 to ensure consistent and

[19]U.S. General Accounting Office, *Small Business Administration: Current Structure Presents Challenges for Service Delivery*, GAO-02-17 (Washington, D.C.: October 2001).

[20]Also included are leadership continuity and succession planning, and creating results-oriented organizational cultures. U.S. General Accounting Office, *Managing For Results: Next Steps to Improve the Federal Government's Management and Performance*, GAO-02-439T (Washington, D.C.: February 15, 2002).

appropriate supervision of SBA's lending partners; however, OCA has other objectives, including the promotion of PLP to appropriate lenders. OFA, also part of OCA, is responsible for providing overall direction for the administration of SBA's lending programs, including working with lenders to deliver lending programs, including 7(a), and developing loan policies and standard operating procedures.

OFA's lender oversight role is to provide final approval of lenders' PLP status and to take necessary enforcement actions against SBLCs. Yet, in its promotion role, OFA works with lenders to deliver lending programs. Thus the only explicit enforcement authority—the authority to revoke PLP status—resides with OFA rather than OLO. The presence of both OFA and OLO within OCA does not afford the oversight function an arm's-length position from the promotion function. The organizational arrangement presents a potential conflict, or at least the appearance of a conflict, between the desire to encourage lender participation in PLP and the need to evaluate lender performance (with the potential for discontinuing lenders' participation in PLP).

Evidence of overlapping responsibilities and poorly aligned resources also can be seen in delays SBA has experienced in completing certain tasks associated with lender oversight. As noted previously, these delays could hamper effective PLP and SBLC oversight by delaying corrective action that might arise from review findings. Since some, but not all, responsibility for the lender oversight function migrated from OFA to OLO, both offices continue to mingle responsibilities for certain functions. The division of responsibility between OFA and OLO has created the need for more interoffice coordination to complete certain tasks. For example, we found substantial delays in finalizing PLP review reports and, as noted earlier, in SBLC examination reports.

SBA's IG concluded that the delays in completing SBLC reports were at least partially due to poor coordination between OLO and OFA, both of which were involved in reviewing the reports. OLO and OFA, respectively, are responsible for oversight and management of the SBLC program. OLO is responsible for SBLC on-site examination and off-site monitoring, while OFA handles day-to-day program management, policymaking, and enforcement of corrective actions. Coordination between the two offices, however, was not formally established and simply evolved over time. The IG said that this informal structure contributed, in part, to the delays in issuing the fiscal year 2001 examination reports. OLO staff said that limited staffing also contributed to delays. For example, OLO began

operations with 3 headquarters staff in fiscal year 2000, a number that increased to 12 by December 2002.

We recommended that SBA separate lender oversight functions and responsibilities from OCA, including those currently done by OFA. This would provide an oversight office with greater autonomy within SBA to match the growing importance of lender oversight in achieving SBA's goal of ensuring that PLP lenders make loans to eligible borrowers while properly managing the financial risk to SBA. While SBA did not respond directly to this recommendation prior to the December 2002 publication of our report, it recently stated in a response to congressional committees that it believes OLO has adequate independence. In addition, SBA maintains there is an advantage to having both OLO and OFA within the same office and working in concert. SBA did state, in March 2003, that it was in the process of drafting policies and procedures governing OLO program responsibilities. We plan to follow-up with SBA on its response to this recommendation.

Madam Chair, Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

For information on this statement, please contact Davi D'Agostino, Director, Financial Markets and Community Investment, at (202) 512-8678 or Katie Harris, Assistant Director, at (202) 512-8415. You may also reach them by E-mail at dagostinod@gao.gov or harrism@gao.gov. Other individuals who made key contributions to this testimony include Toayoa Aldridge, Tom Conahan, and Barbara Roesmann.

Written Record for
The Senate Committee on Small Business and Entreprenership
Zach Gast, Policy & Research Manager
Association for Enterprise Opportunity

Roundtable on SBA Credit Program Reauthorization
April 30, 2003

Thank you, Madame Chairman, Senator Kerry and members of the Committee for the opportunity to participate in this discussion today. My name is Zach Gast, Policy & Research Manager for the Association for Enterprise Opportunity – the national association of more than 450 microenterprise development programs around the United States.

The SBA Microloan Program, which was created as a demonstration program during the Bush Administration, is unique because it was created with the needs of a specific target market in mind – entrepreneurs that need both access to capital and intensive management assistance. The SBA Microloan program provides two types of funding to non-profit intermediaries around the country:

- Loan capital, repayable over 10 years to the SBA, on slightly concessionary terms. This capital is then loaned out by the non-profit intermediary to microenterprises in loans of $35,000 or less. To receive any loan capital, an intermediary must provide an up-front cash match that the SBA holds as collateral along with an assignment of all the loans made with the funds.

- Operational grants to provide intensive marketing, management and technical assistance to assist Microloan borrowers. This assistance is the key to successful outcomes for the businesses that access the SBA Microloan program.

While some have suggested that the SBA Microloan program be replaced with guaranteed bank loans, I would reiterate: Microlending does not serve bankable clients, but works to build businesses – creating revenue, income and jobs – with those individuals to which the banks can not provide loans. In a few cases, the loan sizes may be the same, but across the board, the target market is very different. Most borrowers from the Microloan Program would fall under the bank's criteria, even with a guarantee.

Why is it important to work with this group of clients? In today's economy one can not simply go out and find a job – this is particularly true for the individuals we work with. Some have started microenterprises while others dream of doing so. We are enabling entrepreneurs to increase revenue, generate personal income and create jobs. Recent estimates put the return on investment in microenterprise development at $2.06 to $2.72. Is the federal government willing to invest $1 dollar to receive more than $2 in return?

I would like to offer some additional statistics to detail the work of the Microloan Program. In Fiscal Year 2002, the last year for which public data is available, the SBA Microloan program:

- Closed 2,580 loans, with an average loan size of $14,238, for a total of $36,732,972
- 44% of these businesses were startups
- More than half were minority-owned
- Nearly half were women-owned

Recent research by the Department of Labor has demonstrated that Microloans are our most effective tool in creating jobs. In addition, I would emphasize to members that the Microloan industry is more effective now than ever. Last year's loans account for nearly 1/6th of the programs historical loans – an amazing figure indicating the increasing demand for the program by small businesses across the nation.

I would now like to address the microenterprise industry's suggested changes to the authorizing legislation. We continue to think about ways to improve the program, but would offer the following thoughts today.

As the microenterprise industry has become more advanced, many SBA Microloan Intermediaries have begun to see the need to develop more sophisticated loan instruments to match the needs of our clients. Intermediaries are developing lines of credit and other loan terms that more closely match the cash flow and capital needs of microentrepreneurs across the country. AEO is recommending that the SBA Microloan program be modified to allow these financial instruments to be used within the program.

Likewise, a similar evolution has occurred in the provision of technical assistance. Intermediaries and National Technical Assistance Partners are increasingly being asked to provide more specialized assistance for entrepreneurs – moving beyond generalized technical assistance to sector-specific and technical issues. Intermediaries are meeting this challenge by remaining flexible. Two changes to the SBA Microloan program would facilitate this process. First, the cap on pre-loan technical assistance should be lifted. Second, the limit on out-sourced technical assistance should be lifted. Both of these changes are also being recommended by the SBA – following the lead of Senators Snowe and Kerry, who proposed this change several years ago.

Like many SBA loan programs, the SBA Microloan Program subsidy rate has received increased attention over the past two years. The Association for Enterprise Opportunity looks forward to working closely with the SBA to determine if changes to the model used to determine this subsidy rate are necessary.

Finally, there are a few technical corrections to the Microloan authorization that AEO supports. I would like to thank you for the opportunity to present this information and would be glad to answer any further questions the committee might have.

Statement of Senator John F. Kerry
Roundtable on Reauthorization of SBA's
7(a) Loan Guarantee & Microloan Programs

Good morning. Thank you all for being here. Senator Snowe, I thank you very much for holding today's and tomorrow's roundtables to review the SBA's loan and venture capital initiatives. Both the SBA's programs and the nation's economy have been through extremely uncertain times over the past few years. The reauthorization process gives us the our opportunity to review what the Agency has been doing to provide capital and credit to small businesses in this slumping economy, how its actions match Congress's intent, how we can maximize SBA's resources to create jobs and spur business investment, and what the government's partners – 7(a) lenders, microlenders, 504 certified development companies, small business investment companies, new markets venture capital companies, and small business advocates – recommend based on their day-to-day experiences. I encourage all of you to use this format today and tomorrow to air the issues affecting these critical credit and investment programs and have a healthy and constructive dialogue with us.

As I said a few weeks ago at the roundtable on SBA's entrepreneurial and contracting programs, I oppose SBA's proposal to reauthorize the Agency's programs for six years at level funding. Based on the direction the SBA has been going over the past few years, the Agency needs more frequent oversight, not less. There is a tremendous opportunity for the SBA to help our nation's small businesses, our economy and the more than 2 million Americans who need jobs, yet most of the programs are starved for funding and staff. Level funding for six years is tantamount to a cut when adjusted for inflation, and there is a disconnect between what SBA requested legislatively and what it requested for the budget.

Take for example the microloan program. In the Administration's legislative proposal, for the next six years, starting with FY2004, it has requested a program level of $100 million for microloans and $70 million for technical assistance. However, in its FY2004 budget, it requested less than $2 million to leverage $20 million in microloans – more than a 36 percent cut from the year before – and $15 million for technical assistance. This is one of many reasons SBA continues to lose credibility with the small business community and this Committee.

Let me run through some major concerns I have for the loan programs being reviewed today that should be addressed in a reauthorization package. Starting with the 7(a) loan guarantee program, the Agency's largest small business loan program, I support the trade association's recommended loan levels of $16 billion, $16.5 billion and $17 billion for fiscal years 2004 through 2006. It is reasonable given that the demand for these loans was up around 38 percent the first two quarters of this year.

As part of reauthorization, Congress needs to ensure that SBA and OMB cooperate with GAO as it tries to respond to a Congressional request to validate the new subsidy rate model for the 7(a) loan program. The model appears to be more accurate, and implementing the new model has freed up money in fees and loan dollars to help more small businesses, but it needs to be reviewed by GAO. Unfortunately, reports continue to grow that the SBA is obstructing the validation process. The Agency is undermining what seems to be good work, exacerbating a troublesome working relationship it has with Congress, and perpetuating the public's distrust in what should be the people's government.

And now let me mention a topic that should be addressed today – the authority of credit unions to make business loans, particularly loans to small businesses guaranteed by the SBA. It had been a long-held position by SBA that credit unions are limited membership organizations that are not "open to the public" and therefore in general should not be allowed to participate in a taxpayer paid program. SBA recently revised its position, allowing all credit unions to make 7(a) loans. However, the Agency did not allow the public to comment on its change, and it needs to do that immediately.

Turning to microloans, I first want to acknowledge and thank Committee Chair Snowe for her commitment to SBA's microloan program. She has cared about and actively supported this program for long before she became Chair of this Committee. Together for the past six years, we have either lead written campaigns or introduced joint legislation to increase appropriations and strengthen this program that helps the smallest businesses start and grow. We have been successful on many levels, and I hope that she will reintroduce with me this year our Microloan Improvements bill from last Congress, formerly S. 174, so that we can work towards its enactment as part of the final SBA reauthorization package.

As for needed changes to the microloan program, first and foremost the Administration needs to request adequate funding for microloans and technical assistance for microborrowers. The SBA contends its goals are making more small loans, reaching more minorities, and creating jobs, yet each year the Administration has cut the program and for the second year in a row it has requested more money for its travel budget than for microloans. SBA's rationale for cutting the program more than 36 percent this year is that it believes it can serve micro businesses through the SBA's 7(a) loan program and that making small loans through the 7(a) loan program is cheaper. SBA neglects to disclose, however, that the program's cost is inflated because the microloan subsidy rate is inaccurate. For example, this year, fiscal year 2003, the subsidy rate almost doubled from 6.78 percent to 13.05 percent even though, to my knowledge, the government has suffered no losses from the program. Instead of diminishing the microloan program, SBA should fix the problems and adequately fund it.

In addition to concerns related to funding issues, the Committee is receiving more and more complaints that the SBA takes too long to approve and disburse loan proceeds to the microlending intermediaries. Because of SBA's inaction, intermediaries in Massachusetts and Maine have run out of money to loan and have been forced to turned away small businesses. And because SBA doesn't disburse the loans, the program doesn't loan out all of the microloan dollars available. Then SBA uses that self-created situation as evidence that there isn't demand for microloans. I suggest as part of reauthorization that we enact a provision requiring the SBA to report to its Senate and House oversight committees every month on the status of microloan and technical assistance applications, approvals and disbursements. I welcome other suggestions to address this problem.

Tomorrow the Committee will review SBA's remaining credit and investment programs: the Certified Development Company or 504 Loan Guaranty Program, the Disaster Loan Program, the New Markets Venture Capital (NMVC) Program and the Small Business Investment Company (SBIC) program. The list of changes needed to maximize these programs is long, and I will submit for tomorrow's record a detailed statement regarding my concerns.

Madam Chair, I thank you and your staff for all your work in reauthorizing the SBA's programs and for your collaborative spirit. To all the participants, thank you again for participating in the Committee's roundtables this week, and please let us hear your comments, your concerns and your recommeded changes now, or in writing for the reauthorization record. We want SBA's programs to continue to improve and evolve for the best of small businesses and the nation's economy. I ask that my full statement be included in the record.

Statement of Paul G. Merski
Chief Economist

Independent Community Bankers of America

SBA Loan Program Roundtable

COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
UNITED STATES SENATE

Wednesday, April 30, 2003
428A Russell Senate Office Building

Successful SBA Loan Programs Need Budget Boost

The Independent Community Bankers of America is urging the Bush Administration and members of Congress to adequately fund the successful Small Business Administration 7(a) and 504 loan programs. These important SBA programs are widely used by many community banks to provide needed capital and credit to thousands of small businesses nationwide. Unfortunately, the Administration's Fiscal 2004 federal budget shortchanges the SBA's 7(a) Loan Guaranty Program. While ICBA estimates 7(a) loan demand could exceed $12 billion, the Administration's proposed FY2004 program level to support around $9 billion in 7(a) loans is out of sync with historic loan demand figures and current small business needs.

Excessive Program Fees Must End

High fees associated with the 7(a) loan program make such loans less affordable and less attractive for banks and borrowers alike. In 2001, Congress helped to restore additional budgeting appropriations for the SBA loan programs and to temporarily cut some high SBA loan fees starting October 1, 2002. However, the fee schedule is temporary and higher fees would reduce the program's effectiveness. We urge the Committee of Small Business to help reduce the fees associated with the 7(a) and 504 loan programs.

Fragile Economy Requires Adequate Small Business Resources

Small businesses remain the engines for new job creation and economic growth. Given the current fragile state of our economy, this is no time to dramatically weaken needed small business resources. Or nation's unemployment level has been stuck in the 5.7% to 6% range for too long. Proper resources leveraged for SBA lending will create more jobs. Community banks play a critical role in providing small business lending nationwide, especially through SBA lending programs. As the U.S. economy begins to gains strength climbing out of recession, we estimate the proposed FY 2004 funding level for the SBA 7(a) program will not be adequate to meet the expected small business lending needs next year. Therefore, we urge the Bush Administration and Congress to restore adequate budget appropriations to support $12 billion in 7(a) lending in fiscal 2004. Providing needed capital resources to small businesses will help strengthen economic growth and foster much needed job creation. Thriving small businesses and a growing economy will in turn provide greater payroll and business income tax revenue back to the federal government.

While providing financial services for urban, suburban, and rural regions, forty percent of ICBA members are located in towns with a population of 2,500 or less, where adequate small business lending is critical to the local economy. Community bank small business lending through SBA loan programs fosters the well being of local communities, particularly small towns and rural America. The SBA's small business lending programs have served an important role in small business lending facilitated by community-based financial institutions.

The ICBA pledges to work with Congress to ensure our Nation's small businesses have the access to capital and credit they need to invest, grow, and to provide jobs and continued economic growth. With the fragile state of our current economy, we urge lawmakers to support adequate budget funding levels to maintain the highly beneficial SBA lending programs utilized by community banks to provide small businesses lending. Supporting accurate and adequate appropriation for SBA loan programs would go a long way in preserving a secure and competitive source of credit for small businesses and communities throughout our nation.

The ICBA represents more than 5,000 community-based financial institutions nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, and lending to small businesses, farms, and consumers. ICBA's members alone hold more than $500 billion in insured deposits, $600 billion in assets and more than $365 billion in loans. They employ nearly 239,000 citizens in the communities they serve. Simply stated, our community banks are small businesses that serve the lending needs of small businesses in communities throughout America. Community banks are one of the key sources of credit and other financial services to small business – the most prolific job creating sector of our economy. Small

businesses employ sixty percent of the nation's workforce and have created two-thirds of all the net new jobs since 1970.
For additional information, please contact Paul G. Merski, ICBA Chief Economist & Director of Federal Tax Policy. 202-659-8111.

STATEMENT OF SENATOR LANDRIEU FOR THE SMALL BUSINESS COMMITTEE ROUNDTABLE ON THE REAUTHORIZATION OF THE SMALL BUSINESS ADMINISTRATION'S CREDIT PROGRAMS
April 30 and May 1, 2003

Madam Chairman, thank you for convening this Roundtable meeting to review the Small Business Administration's Credit and Business Lending programs. All members of Congress talk about supporting small businesses, but we truly "walk the talk" and make a commitment to small businesses through the SBA's credit programs. These programs provide the entrepreneur with what they need the most to get their businesses working: investment capital.

I mentioned my appreciation for the Roundtable format in my statement from the first Roundtable meeting the Committee held on the SBA's Non-credit programs. Roundtables are a great means for hearing about the issues surrounding the SBA's reauthorization. However, I still believe that the Committee should hold a formal hearing with the Administrator of the SBA, Hector Barreto, and other witnesses to talk more about the reauthorization before we proceed to a mark-up. The Administration has put together a comprehensive reauthorization package that has several problems. We should have a hearing to discuss those in problems detail with Administrator Barreto and to hear from other witnesses.

The Credit Programs at the SBA are so important for small businesses. We need to take a serious look at all of these programs. The 7(a) Loan Guaranty program, for example, has not been funded adequately for years, subsidy rates have been inadequate, and we are losing lenders out of the program. This only creates uncertainty and in a business environment uncertainty on the government's part is never positive. The Administration's proposal to flat fund the 7(a) program will only add to the uncertainty. Level funding is a cut. In fact, the Administration has proposed level funding for all of SBA's program for the six years of the reauthorization period. I believe that is unrealistic and will make the SBA unable to meet the demand for its programs in the long term.

I also want to mention the New Markets Venture Capital program. We cut the funding for that program in the FY 2003 Omnibus Appropriations Act, effectively cutting off a second funding round. I know in my home state of Louisiana that there were organizations that were ready to apply for some second round funding and now we have lost out on an opportunity. So I would hope that we on the Committee can work together to provide funding for a new round of grants.

Again Madam Chairman, thank you for calling this Roundtable. I do have concerns about the Administration's proposal and I do want to hear directly from Administrator Barreto in a formal hearing about the proposal. Despite those concerns, I know from working with you here in the Senate that you are always willing to develop a bipartisan approach to the reauthorization.

I thank the Chair.

Statement of Senator Carl Levin
Senate Committee on Small Business and Entrepreneurship
Roundtable discussion on SBA Re-Authorization: Credit Programs

I would like to thank all the participants in these roundtable discussions of SBA's credit programs. Input from you, the people actually working with and using SBA's programs, provides our Committee with invaluable insight into how SBA's credit programs are performing on a day to day basis. Your experiences and the feedback you provide allows us to make changes and improvements in SBA's programs where necessary so they can serve you better. For example, we want to grow SBA's credit programs where the need demands it to give small businesses, responsible for creating the majority of new jobs in our economy, access to the credit they need to expand and grow. We want to know which programs are truly effective, such as the microloan program, and give them our full support, and fix or eliminate those that have not achieved their objectives.

The Committee is preparing for reauthorization of the Small Business Administration (SBA). The Administration's proposal for SBA reauthorization is deficient in many ways. Members of this Committee will work to draft a responsible bill that reflects more realistic needs for SBA's programs. Proposing a 6 year reauthorization as the Administration has done, with program levels frozen at FY 03 levels, is totally inadequate. Congress has traditionally reauthorized SBA for three years at a time, not six. A three year time frame allows us to be make the necessary adjustments if subsidy rates for a specific program should rise, or if loan volumes exceed authorized levels. If an SBA loan program continues to see increased demand, such as the 7(a) program has seen, we want to be able to respond by finding ways to expand the program. Based

on past trends, keeping funding level for 6 years regardless of demand would mean turning away small entrepreneurs, exactly the group we are trying to help. It would also mean forgoing the job creation and business expansion that go along with small business loans.

We have seen tremendous growth in both the 7(a) and the 504 credit programs. Congress has responded by making funds available to meet demand or increasing the program level. We want to be able to continue that level of responsiveness to our nation's small businesses and entrepreneurs, many of which have no alternative credit sources.

I hope the reauthorization bill includes two Committee bills that I have cosponsored, the Small Business Drought Relief Act and the Child Care Lending Pilot Act. Both bills will get needed resources to small businesses, the first to small businesses who have been hurt by drought or low water levels on the Great Lakes and elsewhere, and the second to not-for profit day care centers.

I look forward to working with the members of this Committee and the small business community in developing an effective and responsive reauthorization bill. Thank you again for your contributions to this process.

CUNA & Affiliates
A Member of the Credit Union System

Credit Union National Association, Inc.

601 Pennsylvania Ave. NW, South Bldg.
Suite 600
Washington, D.C.
20004-2601

Telephone:
(202) 638-5777
Fax:
(202) 638-7734

Web Site:
www.cuna.org

Daniel A. Mica
President & CEO

May 19, 2003

The Honorable Olympia Snowe
Chair
Senate Committee on Small
Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

Attention: Ms. Lindsey Ledwin, Clerk

Dear Madame Chair:

I really appreciated the opportunity to visit with you prior to the Roundtable on the Small Business Administration's 7(a) program that you convened April 30, 2003 under the auspices of the Senate Committee on Small Business and Entrepreneurship. I was pleased that Mr. Michael Hearne, a former chief financial officer at the Small Business Administration, and currently the Treasurer of Lafayette Federal Credit Union in Washington, DC, as well as a consultant to CUNA, was able to participate in your discussions on CUNA's behalf.

CUNA Supports Sen. Snowe's Leadership

Your leadership on this issue is very important, not only for financial institutions, such as credit unions, which originate business loans for their members, but also for the small businesses in this country that are so vital to our economy. As you know, over fifty percent of those employed in this country work for a small business, which has less than 500 employees. Such businesses generate up to 75% of the new jobs offered in the United States. Yet, over 80% of small businesses rely on credit, often unsecured, high-rate credit card loans, to finance their operations.

Credit Unions Can Play An Important Role in Lending to Small Businesses

I believe that credit unions can play a significant role in helping to provide much-needed credit for small businesses. I would like to be clear on what I mean by that. Contrary to the misinformation that banker groups are disseminating, only

about 1,500 credit unions today make business loans, which can only be provided to members. Also, the average size of a credit union member business loan is about $110,000. Credit unions are not seeking to make speculative commercial loans, as some banker representative have charged, but rather want to respond to a growing need for loans to small businesses that is not being met today.

SBA's 7(a) Program Now Includes All Types of Credit Unions

CUNA is a strong supporter of the Small Business Administration's 7(a) program. However, until recently, most credit unions were barred by an agency legal interpretation from participating in the program.

With the full support of the SBA Administrator, Hector Barreto, who has encouraged credit unions to become involved in 7(a) lending, the General Counsel of the SBA issued a new legal opinion that allows all credit unions, regardless of charter type, to apply for 7(a) status. CUNA strongly supported the SBA's new interpretation and believes over time that it will enable a number of small businesses to obtain financing that they may not have been able to obtain using a commercial bank.

CUNA's Program to Support Small Businesss Lending

Following SBA's announcement of its new interpretation regarding credit unions, CUNA formed an alliance with Newtek Small Business Finance, Inc., a lending service provider committed to assisting small businesses. Led by a former senior SBA official, John Cox, Newtek offers a range of services. As a Small Business Lending Company, it can actually originate a business loan to a qualifying enterprise referred by a credit union. Newtek also offers valuable assistance in underwriting, servicing and liquidating business loans.

Quite frankly, most credit unions do not make business loans, for a variety of reasons. Often, small businesses do not know they can turn to their credit union to obtain much needed funding for their operations. Also, credit unions may not feel they have the resources to develop a member/small business lending operation.

However, CUNA believes this situation is changing as a result of several factors. Small businesses need a source of funding for loans that are around $100,000 or even less. While the need for such loans is growing, the demand for some traditional types of loans such as auto loans, other consumer loans, and mortgage loans, is not as robust as it has been at some credit unions.

Legal/Regulatory Factors that Hinder Member Business Lending at Credit Unions

I believe two regulatory factors will facilitate member business and SBA lending at credit unions. I have already mentioned the new interpretation from the SBA. In addition, the National Credit Union Administration has proposed a new rule for member business lending that will make it easier for credit unions to serve the needs of their small business members.

That said, however, there are still obstacles that thwart SBA and member business lending at credit unions. There is a 12.25% of total assets statutory limit on member business lending at credit unions, which is a significant restriction other financial institutions do not face. CUNA wants to work with Congress at the appropriate time to expand or eliminate this limitation.

Also, in CUNA's, view SBA 7(a) lending at credit unions would be enhanced if several improvements were made including centralizing the approval process for 7(a) applicants and streamlining the loan participation process to help support and provide the capacity for a larger number of small business loans made through participating institutions. We want to continue working with the SBA and Congress to achieve these results to benefit small businesses as well as financial institutions.

Some credit unions have expressed concern about the processing of their 7(a) applications. We believe the SBA is aware of these concerns, and we encourage them to take steps to approve eligible applications in a timely manner.

Credit Unions' Member Business Lending Has Been Thoroughly Reviewed by the Treasury Department

Before closing I want to address a statement made by a banker representative at your Roundtable, which may have left a false impression about credit unions. The individual indicated that banks are concerned that some credit unions may jeopardize the 7(a) program because their default rates may be higher than banks on member business lending.

In 2001, the U.S. Department of Treasury, at the direction of Congress, issued a study of member business lending at credit unions as compared to commercial lending from banks. The study shows that the delinquency rate and default rate for credit unions' member business loans are lower than those for commercial banks. The study, which is very thorough, may be found at Treasury's website at http://www.treas.gov/press/releases/reports/mbl/study.doc

In closing, CUNA appreciates the opportunity to place these additional statements in the record of your Roundtable on the SBA's 7(a) program. I look forward to visiting with you again in the near future about this and related credit union issues.

Sincerely,

Daniel A. Mica
President & CEO

May 14, 2003

U.S. Senator Olympia J. Snowe, Chair
Committee on Small Business and Entrepreneurship
154 Russell Senate Office Building
Washington, DC, 20510-6350

Attention: Ms. Lindsey Ledwin, Hearings Clerk

Dear Senator Snowe:

It was a pleasure participating in the April 30, 2003, 7(a) Round Table. Thank you for the opportunity to submit additional information for the record. Due to time restraints, my verbal presentation regarding the need to establish a national PLP program requires some supportive explanation. Herein, I will provide additional explanatory information, which explains in part why the current PLP renewal and expansion procedures are flawed and therefore in need of change.

1) It has driven good lenders from SBA loan participation.

   - The 7(a) lending industry have lost a number of lenders who had become frustrated with the 7(a) PLP renewal and expansion process as well as other 7(a) program impediments.

   - In unison, the 7(a) lending industry that operates as a PLP lender in more than one SBA field office has appealed to SBA for several years to utilize national operating statistical data when evaluating the lender's performance for PLP renewal and/or expansion of their PLP authority. Unfortunately, SBA continues to utilize only data tied to each individual field office, district and branches.

2) It makes a mockery of SBA's lender examination results!

   - An SBA 7(a) lender can pass all Agency examinations and audits with flying colors and still not be considered worthy of PLP status if individual SBA field office personnel do not recommend the lender for PLP status for whatever reason they may use!

   - Rather than use a lender's "total" statistical operating data on such issues as currency, default, loan volume, and so forth, each SBA field office uses only the data within their individual office to measure the lender's performance. Often, this unfairly distorts the lender's operating numbers. For instance, overall a lender may have a currency rate above 90%, but if the lender has only done a few loans in an individual office, one or two loans being delinquent adversely distorts the lender's delinquency numbers dramatically.

3) It discourages lenders from committing resources to the SBA 7(a) loan program!

- Unless a lender can operate as a PLP lender, it is not economically feasible to build a 7(a) supporting staff. Applicants normally go to PLP lenders who have been giving the authority to make credit decisions, thus expediting the process. For instance, a PLP lender can say, "if we approve the loan, it is a done deal!" A non-PLP lender must say, "after we approve your loan we must send your application to the SBA field office and if they approve it, we can make the loan." Given these circumstances, no applicant or loan broker would take a loan to a non-PLP lender. Perhaps even worse, very few "quality" business development officers would ever go to work for a non-PLP lender because business development officers know they cannot compete without PLP authority.

- By only being assured of PLP status within a field office for a maximum of two years at a time, the PLP lender is not motivated to build a strong infrastructure because the lender does not know if they will be able to compete with other lenders in the future. It discourages the lender from building a large infrastructure.

4) It has opened the door for some SBA officials to "blackmail" lenders!

- Numerous examples of SBA field offices "blackmailing" perspective PLP lenders have been received by the National Association of Government Guaranteed Lenders (NAGGL). Many of these examples have been referred to SBA's Central Office by NAGGL. Rumor has it, that GAO and/or the Office of the Inspector General may be investigating such abuses of authority. Lenders being asked to contribute funds to various SBA projects to obtain or retain PLP authority, or lenders being told that approving some "soft" loans might help assure PLP status are not uncommon. A lender is fearful of making an issue of such circumstances for fear of retribution by SBA field offices.

- Even SBA Central Office uses intimidation of lenders in its PLP scoring to force lenders to do the type of loans the Agency is promoting at the time. To become or retain PLP status the lender must follow the SBA's desired lending strategy regardless of the individual lender's business strategy. Even if the lender follows all SBA 7(a) rules and regulations to the letter, the lender may be forced out of being a PLP lender because of the manner in which PLP scores are allocated.

5) Based upon national performance data, a lender can be an "outstanding" lender and still not be approved as a PLP lender. In fact, the lender has to prove and reprove itself as many as 80 times every two years.

- Regardless of a lender's overall performance the actual PLP determination is based upon the whims and biases of SBA officials in 80 different field offices.

- It is very common for a multi-office PLP lender to hear an SBA field office official say "we want to see how you operate before we grant PLP status." Such statements are heard whether the lender desires to become PLP in a second or third territory, or if the lender wants to expand from operating as a PLP lender within 75 offices to 76 different. A lender is forced to reprove itself over and over again, which is terribly frustrating!

6) It makes it difficult for a lender to market the SBA program!

   - A major SBA 7(a) lender cannot advertise itself as "national SBA PLP lender," therefore; the lender's marketing activities are limited. It is not cost effective for a multi office lender to contract with national, or even regional advertising sources if the lender is not able to claim national or regional PLP loan processing authority.

   - SBA lenders are placed in a position of saying "we can give applicants good service in X district," but in other districts and branches the lender cannot provide clients with equally good service. This is difficult to explain in marketing materials and in other means of advertising.

Numbers one through six are issues that I mentioned in my verbal presentation, however, there are additional points that warrant being mentioned. They include:

- Some SBA district/branch offices realize that the more lenders operating within their marketplace, the greater chance for economic growth. While other SBA districts/branches have their "pet" lenders and do not want to open the marketplace to new lenders.

- If a PLP lender does not make at least four loans over a two year period in a field office the current system will not let the office recommend continued PLP status without special effort in the narrative section of the PLP worksheet. However, it should be fully understood that as a practical matter it can cost a lender dearly if their PLP is not renewed. On the other hand, it costs SBA nothing if a lender is PLP and does not use the authority.

Current procedures result in the PLP renewal and/or expansion process to be anything but consistent and uniform. With a national PLP program based upon a reasonable set of stringent operating criteria the Agency and Congress would have an even better handle on the overall performance of its major 7(a) lender partners. We hope you will support the proposed legislation establishing a national PLP program.

Respectfully submitted,

Deryl K. Schuster,
Executive Vice President
Business Loan Express, LLC

DKS:lw

COMMENTS FOR THE RECORD

2600 Virginia Ave. N.W.
Suite 123
Washington, DC 20037
T 202-298-6449
F 202-298-5547
www.apprasialinstitute.org

Executive Vice President
John W. Ross
312-335-4110

Vice President,
Public Affairs
Donald E. Kelly
202-298-5583

Testimony of
Alan Eugene Hummel, SRA
President, Appraisal Institute
Chief Executive Officer, Iowa Residential Appraisal Company
Des Moines, Iowa

On Behalf of the
Appraisal Institute and
American Society of Appraisers

Before the Senate Committee on Small Business and Entrepreneurship
On

SBA Reauthorization Roundtable: Credit Programs Part 1 & Part 2

Presented by
Alan Eugene Hummel, SRA
President, Appraisal Institute
Chief Executive Officer, Iowa Residential Appraisal Company
Des Moines, Iowa

May 15, 2003

Testimony of Alan Eugene Hummel, SRA
On Behalf of the Appraisal Institute and American Society of Appraisers
Before the
Committee on Small Business and Entrepreneurship
United States Senate

Madam Chair and members of the Committee, I am Alan Eugene Hummel, President of Iowa Residential Appraisal Company in Des Moines, Iowa and 2003 President of the Appraisal Institute. I am pleased to provide official comments to the SBA Reauthorization Roundtable on behalf of the more than 25,000 members of the Appraisal Institute and American Society of Appraisers.

Real estate appraisals are used in virtually every program of the Small Business Administration to help establish market value of real estate and other property held as collateral for loans made to small businesses. Under the SBA 7(a) program, a prospective borrower might present property that is owned by the business to use as collateral to receive a loan for working capital expenses. In determining the size and adequacy of the application, financial institutions rely on the appraisal to estimate the value of the property (collateral) and subsequently the adequacy of the loan.

SBA's 504 loan program can be used to purchase fixed assets such as machinery, equipment and real estate. The appraiser typically does not know which SBA program is being used, as the appraiser is simply given appraisal assignment of a specific property by the financial institution or small business lending company.

Unfortunately, appraisers and lenders must rely on appraisal guidelines written by the SBA that lack clarity and reflect less than a full understanding of the appraisal process. What has resulted is confusion amongst both appraisers and lenders over the type of appraisals that should be ordered by financial institutions.

In addition, the appraisal guidelines do not adequately address business enterprise or "going concern" values. If this issue is not addressed, SBA will continue to take huge losses on loans that have been made on the value of the business rather than the value of the property.

We hope the Senate Committee on Small Business and Entrepreneurship considers these issues as it looks to reauthorize SBA's credit programs this year. I will detail more specific concerns below.

Issue 1: Going Concern Values

Many SBA-backed loans are used to acquire businesses which consist of real estate, furniture, fixtures and equipment and what is known as "ongoing business value." Properties with these features include: convenience stores, restaurants, motels, bowling alleys, golf courses, car washes, lube centers, and the like.

An appraisal of this type of property estimates a "going concern value." Because "going concern value" may include the business' value as well as personal property assets it should be differentiated from the

value solely of the real property. Unfortunately, SBA *Standard Operating Procedure (SOP) 50-10* fails to address this very important issue. Nowhere in the SOP is the "going concern value" discussed and there is no procedure or directive on how to treat this type of property during the appraisal process.

SBA is faced with a very serious problem -- appraisers are oftentimes hired to value this type of property, yet sometimes they incorrectly state that the appraised value is of the real property, when they have accounted for the business' value and personal property assets as well. Subsequently, the lender makes the loan believing that they have issued a loan on the real property only. If the business fails, another appraisal is ordered during liquidation proceedings, and the value may be reported as much as 50% less than the original appraisal prepared by another appraiser because there is now no business or "going concern value" associated with the real property. As a result, the SBA is left with a property that is worth half as much as it was originally loaned for, which results in a major loss to the agency. Recently, SBA experienced such losses, such as in a number of convenient stores throughout the country.

A key issue SBA should address is whether or not it wants appraisals to reflect the going concern or just the real property. The SOP should clarify for both lenders and appraisers what value it requires. Perhaps going concern values should only be used to value the purchase price of the going concern and real estate values should be used to value collateral value.

Once that is clarified, the SBA should ensure that qualified appraisers are used for these valuations. One way SBA might address this problem is to modify its appraiser qualifications to require appraisers who provide "going concern" appraisals to demonstrate experience and education relevant to such assignments.

The Appraisal Institute Course 800 currently deals with separating real and personal property assets. It provides the theoretical and analytical framework for separating the tangible and intangible assets of operating properties. Through discussion, lecture, readings, role-playing and case studies, participants actively solve problems related to "going concern value." The American Society of Appraisers also has practitioners specializing in personal property and business valuation that can be relied on for such assignments.

Additionally, SBA could place greater emphasis on holding lenders and appraisers accountable when they do not adhere to these guidelines. Recently, the SBA incurred loses on loans where the appraisals were significantly inflated, improperly underwritten or misunderstood by the lender. When a business fails, the only collateral left is the real estate, and that value appears significantly lower because of the going concern issue stated above. Situations like these can contribute to significant losses to SBA programs, and this issue warrants the attention of SBA.

Issue 2: The Competence of the Appraiser

The issue SBA loans against going concerns values also involves the competence of real estate appraisers as much as with the SBA appraisal guidelines. Whether the SBA appraisal guidelines are clear or not, the appraiser should make the distinction between real property and personal property in the appraisal report. The appraiser should not appraise business value or personal property if they are not competent in such assignments, and doing so is a violation of the Uniform Standards of Professional Appraisal Practice.

Appraisers that violate these standards should be referred to the appropriate state appraisal board for possible disciplinary action. The SBA should also hold appraisers and lenders accountable if these standards are violated.

There is a need to train real estate appraisers on these issues, as this is an emerging issue in our profession. As stated above, the Appraisal Institute and the American Society of Appraisers have courses that address going concern valuation and they are being offered throughout the country.

Since SBA backs so many loans involving going concern values, it would be helpful for SBA to have more resources for training of SBA staff and SBA approved lenders and appraisers on these issues. We encourage Congress to consider providing SBA more resources to address these issues in the SBA reauthorization this year.

Issue 3: SOP 50-10 Appraisal Guideline Inconsistencies
We have a concern with language in SOP 50-10 which states that loans under $1,000,000 require a "Limited Appraisal" while loans over $1,000,000 must have a "Complete Appraisal."

To an appraiser, the terms "limited appraisal" and "complete appraisal" do not fully explain the assignment absent further instructions. According to our members, the lack of guidance in this area causes confusion amongst appraisers regarding the kind of complete appraisal SBA requires. This problem is made worse by non-regulated lenders and small banks that do not have compliance departments experienced with the *Uniform Standards of Professional Appraisal Practice (USPAP)* and the appraisal process.

According to USPAP, there are three types of appraisal reports: *Self Contained, Summary* and *Restricted Use*. There are two types of *appraisals*, Complete and Limited. "Limited Appraisals" are appraisals that usually involve the elimination of one or more of the three traditional approaches to value. The key difference is that the term "Complete Appraisal" means that there are no such Departures from USPAP.

The issue to be addressed by the SBA is whether a "Complete Appraisal" means a Self Contained Report of a Complete Appraisal or a Summary Report of a Complete Appraisal (the Restricted Use option would not apply to SBA loans). Clarification is also needed on whether the reference to a "Limited Appraisal" means a Summary Report of a Limited Appraisal.

SBA might address this issue in two specific ways:

1) SBA could review the different types of appraisals and appraisal reports to determine which will provide sufficient detail for the SBA and other intended users in making sound lending decisions. SBA should then amend the SOP 50-10 to give lenders and appraisers further guidance on the new SBA complete appraisal requirement. One such policy could require a "Summary Report of a Complete Appraisal" appraisal for loans under $1,000,000 and a "Self-Contained Report of a Complete Appraisal" for loans greater than $1,000,000.
2) Another option would be for SBA to require strict compliance with USPAP and allow the appraiser and the client to decide the level of appraisal and type of report appropriate, doing away with a loan-appraisal threshold entirely. Under these circumstances, the type of appraisal (complete or limited) would be based upon the purpose and intended use of the appraisal report. The

appraiser's "scope of work" would subsequently define what is to be done in the development of the appraisal.

The SBA could also adopt, wherever possible, the Interagency Appraisal and Evaluation Guidelines adopted by four of the five federal financial institutions regulators in 1994. Many of the definitional problems encountered by appraisers and lenders (limited vs. complete appraisals) that have been identified in SOP 50-10 could be solved if the SBA referenced the Interagency Appraisal and Evaluation Guidelines. Where it is not possible to adopt the Interagency Appraisal and Evaluation Guidelines, we suggest the language contained in the Guidelines be incorporated into the Standard Operating Procedures. We have attached a copy of the Interagency Appraisal and Evaluation Guidelines in this testimony.

Issue 4: Credit Union Appraisal Policies

Both Issue 1 and Issue 2 are relevant to a third concern resulting from recent changes to allow approximately 1,500 credit unions to participate in SBA credit programs. Generally speaking, credit unions are not used to making business loans. Unlike federally-regulated financial institutions, credit unions are not required to comply with the Interagency Appraisal and Evaluation Guidelines of 1994, discussed above. When the Interagency Appraisal and Evaluations Guidelines were adopted in 1994, the National Credit Union Administration was the only federal financial institution regulator that did not adopt them.

In addition, unlike most large banks, which typically have staff on hand to review the work of fee appraisers, credit unions typically do not have in-house appraisers to perform quality control. Credit unions are also not typically well-versed on appraisal procedures or methodologies.
The definitional problems outlined in Issue 1 and Issue 2 will likely be magnified through credit union involvement in SBA loans. In fact, it is further reason for the SBA, and Congress through the reauthorization of SBA's credit programs, to address the deficiencies within Standard Operating Procedures 50-10 before SBA backed financing is further in jeopardy.

For further information

We appreciate the opportunity to provide comment on SBA appraisal issues. We hope that you consider these suggestions during the course of improving SBA lending programs and reauthorizing the SBA credit programs. In the coming weeks, our Washington office will contact you to arrange a meeting with you and your staff. Should you have any questions, please contact Donald Kelly, Vice President of Public Affairs, Appraisal Institute at 202-298-5583, dkelly@appraisalinstitute.org or Ted Baker, Executive Vice President, American Society of Appraisers at 703-733-2199, tbaker@appraisers.org.

U.S. Senate Committee on Small Business and Entrepreneurship

Additional Information

Community Bank Originated Small Business Loans

- Effective credit underwriting of small business loans by community bank lenders depends as much on a thorough understanding of qualitative loan and borrower characteristics as on the quantitative aspects that larger lenders almost exclusively rely on. The significance of qualitative considerations in small business loan underwriting makes it more difficult for borrowers to shop for better rates among several lenders, and makes long-term lender-borrower relationships more advantageous to both parties.

- These advantages help explain why community banks remain a meaningful source of small business loans despite the fact that such loans would theoretically be an attractive business for larger players. By nature, fast growing regional and money center banks are poorly suited to providing the kind of individual service and qualitative analysis that is the backbone of a successful small business lending practice. When small business borrowers' needs can not be met with a credit-scored product, larger lenders typically cede this business to smaller banks.

Community Banks and the Banking Industry: Key Facts

- In terms of assets, community banks constitute a large but highly fragmented segment of the overall banking industry.
- As of the end of 2002, there were nearly 8,000 community banks (banks with total assets under $1 billion) in the US, accounting for 98% of all US banks.
- Total assets held by community banks exceed $1.6 trillion, with total loans topping $960 billion.
- There are approximately 1,170 banks in the USA with assets between $250 million and $1 billion.
- These 1,170 banks account for over 12% of the total US banking assets and 14% of the bank population.
- This market segment has approximately $440 billion of loans.

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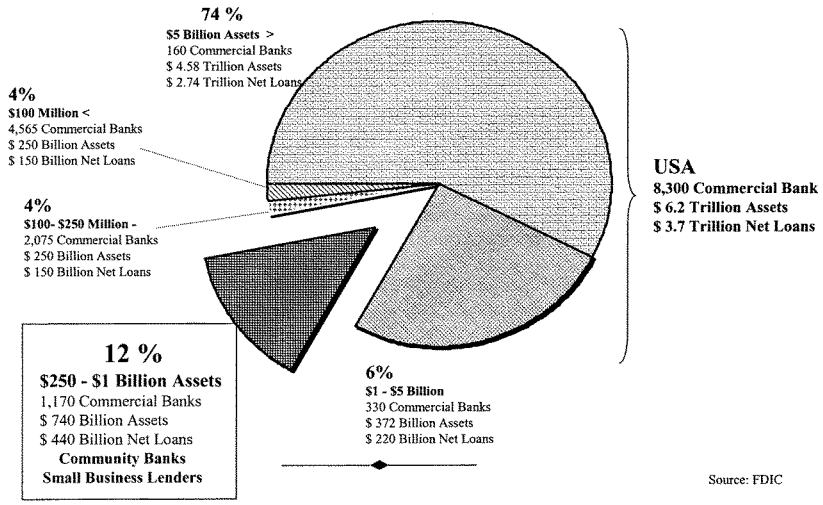
Commercial Bank Asset Distribution



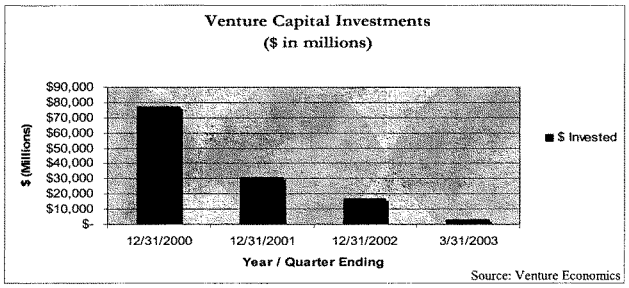
Source: FDIC

Increasing Demand for Small Business Lending

- NAGGL forecasts indicate continued demand for increasingly high levels of small business loans, prompting the request for historically high program levels for 7(a) loans.

- Small business loan demand has increased dramatically over the past several years due to the decrease in venture capital dollars available to small businesses. Due to precipitous declines in the availability of venture funding since 2000, many financing needs for some established businesses may now return to the commercial lending arena.

- The following graph illustrates how venture capital dollars have diminished for later and expansion stage funding.



Liquidity and Funding Issues

- Far different from small business commercial lending, the standardization and nationalization of consumer and residential lending has largely forced community banks out of those lines of business. Lacking the economies of scale necessary to generate fee income from other financial services, community banks' reliance on commercial lending as their primary line of business and their only means of growth has the potential to lead to rising borrower interest rates if reasonably priced sources of loan funding are not available to these lenders.

- Intense competition for deposits has eroded the community bankers' primary source of affordable funding, creating a shortage of liquidity with which to originate and fund new commercial loans. The result has highlighted an industry-wide problem: unlike their larger counterparts, community banks cannot access the capital markets to generate the liquidity necessary to meet their customers' loan demand.

- The lack of liquidity, in turn, undermines community banks' ability to make new loans, grow, and remain a vital part of community and regional economic systems. While the liquidity crisis has taken years to develop, and while it will wax and wane to some degree depending on the economic climate, industry insiders agree that it has become a permanent fixture on the community banking landscape.

- A sample of 25 smaller lending institutions in our regional marketplace shows the significance of this liquidity phenomenon for certain lenders. Loan to deposit ratios at the end of last year range from approximately 70% to well over 150%.

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	Bank Name	Location	Year Est'd	Asset Size	Equity Capital	Deposit Base	Net Loans and Leases	Loans to Deposits
1	American National	Danville, VA	1909	605,274	63,046	475,344	402,066	84.58%
2	Benchmark Community Bank	Kenbridge, VA	1971	261,319	23,418	199,214	198,238	99.51%
3	Southside Bank	Carson, VA	1910	401,054	47,512	318,713	203,533	63.86%
4	Central Virginia Bank	Powhatan, VA	1973	283,663	22,778	209,067	142,751	68.28%
5	Bank of Botetourt	Buchanan, VA	1899	179,746	15,100	144,366	115,884	80.27%
6	Bedford Federal Savings	Bedford, VA	1935	257,354	22,547	179,919	223,563	124.26%
7	First National Bank	Christiansburg, VA	1905	642,546	56,865	567,733	463,350	81.61%
8	FNB Salem Bank & Trust	Salem, VA	1978	350,075	49,371	281,567	253,752	90.12%
9	National Bank of Blacksburg	Blacksburg, VA	1891	381,100	38,602	340,752	236,194	69.32%
10	Lexington State Bank	Lexington, NC	1949	851,049	73,794	697,210	638,264	91.55%
11	The Hometown Bank	Clyde, NC	1926	723,097	71,394	509,131	461,447	90.63%
12	First Bank	Troy, NC	1934	1,217,497	123,878	1,077,546	1,007,312	93.48%
13	Valley Bank	Roanoke, VA	1995	248,713	18,781	182,308	183,559	100.69%
14	Bank of Granite	Granite Falls	1906	698,602	109,900	563,391	519,778	92.26%
15	Peoples Bank	Newton, NC	1912	643,337	60,877	516,215	524,187	101.54%
16	East Carolina Bank	Engelhard, NC	1919	385,995	39,342	301,261	385,995	128.13%
17	Southern Community Bank	Winston-Salem, NC	1996	611,284	56,959	449,764	415,956	92.48%
18	FNB Southeast Bank	Reidsville, NC	1910	733,733	62,964	606,075	556,554	91.83%
19	First National Bank	Shelby, NC	1874	607,693	85,794	400,595	301,239	75.20%
20	First National Bank & Trust Co.	Asheboro, NC	1907	618,387	58,522	491,685	399,362	81.22%
21	Lighthouse Community Bank	Hilton Head, SC	1996	625,234	41,217	410,616	550,733	134.12%
22	Provident Community Bank	Union, SC	1934	333,408	33,645	201,933	159,353	78.91%
23	Asheville Savings Bank	Asheville, NC	1936	480,724	47,356	379,658	375,649	98.94%
24	Four Oaks Bank & Trust	Four Oaks, NC	1912	317,655	29,184	252,507	226,630	89.75%
25	Auburn Bank	Auburn, AL	1907	502,674	37,210	395,654	255,568	64.59%
	Total / AVG		1931	**12,961,213**	**1,290,056**	**10,152,224**	**9,200,917**	**90.63%**

All Data as of 12/31/2002

Limitations faced by Community Bankers

- Community banks also can be limited in their ability to originate certain small business loans that do not fit with the specific lender for one reason or another. In surveying community banks around the region, we find that they often cite their inability to make a loan if it is too large for their bank (typically less than $1 million) or they are fully allocated to a particular type of credit (either based on an individual borrower, industry or asset class). These limitations arise because the lack of a viable secondary market means the bank must carry the loan on its books rather than having the ability to originate and sell the loan as they can do with residential mortgages.

- Beginning in the 1970's, in response to the dwindling number of larger banks offering correspondent services, the first "bankers' banks" began appearing. These were banks created and owned by groups of community banks and designed to satisfy the correspondent services needs of their member institutions. Over time, the bankers' banks began offering more services, including assistance with finding participants for loans, a forum for communication between member banks, and the sale of securities at favorable rates. While the bankers' banks are more or less effective in providing a range of services, they are limited by their regional boundaries of operation, and they have not been successful in providing efficient secondary markets for the sale or funding of non-standard small business loans.

A Capital Markets Funding Solution

- For many other asset classes, bond investors in the capital markets provide funding for these lending activities at reasonable rates by purchasing pooled debt securities backed by the underlying assets.

- The relatively high coupon rates demanded by bond investors on securities backed by small business loans reflect a substantial risk premium associated with community bank originated small business loans. The performance history of such loans clearly demonstrates that they are not as risky as these bond coupons would suggest.

- Because of their small size, community banks typically have relied on larger institutions or on collective action by multiple community banks to sell loans or find other banks willing to syndicate loans.

- This situation points to the need for an efficient loan sale program or a capital markets-based loan funding program. These would serve as effective tools to provide community bank lenders with needed liquidity to increase the availability of small business loans and to help maintain interest rates at reasonable levels for small business borrowers.

Contact Information:
Gryphon Capital Advisors, Inc.
10 South Jefferson Street
Roanoke, Virginia 24014
office: 540.985.6609
fax: 540.985.8656

POST ROUNDTABLE QUESTIONS

Post-Roundtable Question
Committee on Small Business and Entrepreneurship
To
Davi D'Agostino, Director
Financial Markets and Community Investment, U.S. GAO

"SBA Reauthorization: Credit Programs"
April 30, 2003

Question submitted by Senator John Kerry, Ranking Member:

1. On November 21, 2002, Chairman Manzullo, Ranking Member Velazquez and I made a written request for GAO to review the new subsidy rate model for the 7(a) loan guarantee program that was developed by the SBA with the Office of Federal Housing Enterprise Oversight. We continue to hear complaints from the small business community that SBA is not forthcoming with information about how the model was developed, raising concerns about the future outcomes of the model for the 7(a) loan program. When can Congress expect GAO's review of the new subsidy rate model for the 7(a) loan guarantee program to be completed?

Ms. D'Agostino's response:

As I mentioned briefly at the Roundtable, our work at SBA for the Committee has been delayed due to cumbersome procedures SBA now has regarding working with GAO. This includes our work in analyzing the 7(a) loan subsidy model. SBA recently changed the liaison for GAO from the Chief Financial Officer office to the Office of Congressional and Legislative Affairs (CLA). CLA ha s put in place cumbersome procedures that have slowed our work to a port where work on the review of the model that could have been completed in 3-4 months is going to take more than 9 months. For example, all communications must go through CLA and CLA insists that meetings be scheduled so that their staff can be present—even if other times are more convenient for SBA program offices and GAO. In addition, there are cases where we are not getting timely or complete information in response to our requests and we have to keep going back and asking for the complete information or documents—particularly in our work on SBA's transformation efforts and on the 7(a) credit subsidy model.

As of May 23, 2003, we had obtained the necessary data from SBA to conduct our analysis of the subsidy model and expect to issue a final report on our work by September 30, 2003.

Post Roundtable Questions, Committee on Small Business and Entrepreneurship
"SBA Reauthorization: Credit Programs"
April 30, 2003

Question from Senator Snowe, Chair
What actions can the Federal government take to increase the accountability of the Microloan Intermediaries for the Federal funds spent by the Intermediaries on technical assistance to small businesses?

Question response provided by Mary Mathews, Northeast Entrepreneur Fund, Inc. in Minnesota; and Ellen Golden, Coastal Enterprises in Maine.
May 23, 2003

Response:
Current processes provide accountability for technical assistance grants provided by the SBA to Microloan Intermediaries. Intermediaries complete a portfolio identification report for each new loan. Both hard copy and online versions of the report are provided to the SBA within 7 days of the loan closing. In addition to loan and borrower demographic information, the report includes a listing of the type and amount of pre-loan technical assistance provided to the borrower and a post loan technical assistance plan.

The SBA continues to take measures to increase their efficiency and effectiveness in measuring Microloan program performance. Portfolio reports, now submitted in hard copy, will soon be reported online providing the SBA with more tools for closer monitoring of portfolio quality. Current loan monitoring reports include information on the whole portfolio and the status and performance of each loan.

Other testimony provided to this Roundtable demonstrates the critical connection between microloans and the technical assistance provided by the Intermediary. Intermediaries are accountable to the SBA because the money we lend to borrowers is borrowed from the SBA as a 10-year loan. We are not aware that the SBA has lost any of money lent to Intermediaries through the Microloan program. We sign loan documents that commit us to pay back borrowed funds to the SBA. Successful repayment of microloans to the Intermediary and ultimately to the SBA is tied closely to the quality of the technical assistance provided and is a measure of accountability.

A Recommendation for Increased Accountability:
An Intermediary's technical assistance grant is provided on a reimbursement basis, providing additional accountability for the SBA. We must perform the work (deliver technical assistance) to receive payment. Each request is accompanied by a report describing overall activity against annual goals. However, the report format does not currently request information about the type and amount of technical assistance a borrower receives. This could be added to the report, to collect additional information, using a simple format similar to the report showing a borrower's pre-loan technical assistance (on the Portfolio Identification Report).

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