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# SBA'S MANAGEMENT OF ITS CAPITAL ACCESS PROGRAMS

## HEARING

BEFORE THE

## COMMITTEE ON SMALL BUSINESS
## UNITED STATES
## HOUSE OF REPRESENTATIVES

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# SBA'S MANAGEMENT OF THE CAPITAL ACCESS PROGRAMS

**WEDNESDAY, JUNE 6, 2012**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
*Washington, DC.*

The Committee met, pursuant to call, at 2:16 p.m., in Room 2360, Rayburn House Office Building, Hon. Sam Graves (Chairman of the Committee) presiding.

Present: Representatives Graves, Chabot, Mulvaney, Tipton, Landry, Herrera Beutler, West, Ellmers, Velázquez, Schrader, Critz, Clarke, Cicilline, Richmond, and Owens.

Chairman GRAVES. I call the Committee to order, and today we welcome back to the Committee SBA Administrator Karen Mills. Thanks for being here, Administrator.

Administrator Mills is well aware of the Committee's interests and role in making sure that SBA's financing programs are not only serving the needs of small businesses, but that they are also being managed in a way that safeguards taxpayer dollars.

The Committee has held a variety of hearings that have highlighted both the needs of small businesses in accessing capital and the needs of lenders for clear and consistent regulatory guidance. During a time of fragile economic recovery, when we are looking to our small businesses to help create growth and jobs, how to meet the financial needs of these firms is of great importance.

In fiscal year 2013, the SBA requested a 67 percent increase in subsidy to cover the costs of its financing programs, while lowering the authorization level in the 7(a) and 504 programs. As the SBA financing programs become more expensive to operate, it is vital that we look for ways to reduce costs to the taxpayers. This means making sure the SBA is effectively managing its programs in a transparent manner, reducing paperwork burdens, and conducting effective oversight of lenders.

Today we are here to examine the procedures that SBA uses to manage its financial assistance programs. We will also look at how SBA undertakes its mission of overseeing its $90 billion loan portfolio and controlling costs.

For the SBA lending programs to be effective, they must control not only costs, but also control risk. We look forward to learning more about how SBA sets policy for its financial assistance programs; to find out what SBA is doing to be more transparent to its lending partners and to the public; and how SBA is managing risk to the taxpayers.

SBA must foster the partnership between agency and its private-sector lending partners so that the SBA lending programs can achieve their statutory mission of serving the needs of small businesses. At the same time, we understand the SBA needs to exercise robust and effective oversight of its lending partners, who are often given a great deal of discretion to obligate taxpayers on behalf of the SBA.

With that, I now yield to Ranking Member Velázquez for her opening statement.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

For the past 2 years, our Nation's economy has experienced steady private-sector job growth. The unemployment rate, which peaked in October 2010 at 10 percent, has fallen by almost 2 percentage points. But these gains have not been enough to overcome the high hurdle in unemployment. If there is any takeaway from last week's disappointing job numbers, it is that we still have a long road ahead of us with millions of Americans who are seeking work that cannot find it.

This is why small businesses must remain front and center to our recovery. They remain our single greatest source of new jobs, but in order for entrepreneurs to play their traditional job-creating role, it is essential that they have access-to-capital. It is the fuel for innovation and economic expansion across the spectrum of entrepreneurship.

However, small businesses face real challenges in the capital markets. While lending conditions and credit standards have improved significantly over the past year, companies' balance sheets have not yet fully recovered. Recent economic indicators also raise doubts as to whether the flow of affordable credit will be sustained.

In past recoveries the Small Business Administration's access-to-capital programs have been critical to providing small firms with a stable source of credit. While the SBA had some success in leveraging these programs during the worst of the downturn, recent policies have steered some less-than-favorable changes. Costs in the 7(a) and 544 loan programs are escalating rapidly. Lending is stagnant, and small-dollar loans to start-ups are on the decline.

During today's hearing I am hopeful that we will not just tout past successes, but instead focus on what the agency is doing to reverse these negative trends. These are real problems, and no amount of window dressing or clever marketing can make up for the growing gap in small business credit. Getting loans in the hands of would-be entrepreneurs has never been more important. Doing so is not just critical to reducing unemployment, but growing our economy for the long term.

On that note I would like to thank Administrator Mills for appearing before the Committee today. I am interested in hearing your thoughts on how best to meet entrepreneurs' capital needs so that they can continue to create new jobs.

With that, I yield back. Thank you, Mr. Chairman.

Chairman GRAVES. Thank you.

As I mentioned in my opening statement, our witness today is the Honorable Karen Mills, Administrator of the SBA. Ms. Mills has been the Administrator since 2009.

Welcome back to the Committee. We appreciate your coming in.

**STATEMENT OF KAREN MILLS, ADMINISTRATOR, UNITED STATES SMALL BUSINESS ADMINISTRATION**

Ms. MILLS. Thank you very much, Mr. Chairman. Chairman Graves, Ranking Member Velázquez, members of the Committee, thank you for inviting me to testify on SBA's lender oversight program. I have submitted my full written testimony to the Committee, which I ask to be made part of the hearing record.

Our goal at the SBA is to ensure that small business owners and entrepreneurs across the country have access to the capital and help they need to grow their businesses and create jobs. Today our lending is running at above 2008 levels following a record year in 2011 in which we supported more than $30 billion in lending to over 60,000 small businesses. In addition, our small business investment companies also had a record year, putting $2.6 billion directly into the hands of more than 1,300 high-growth businesses.

While commercial lending has improved, we know that gaps remain. Small-dollar loans and loans in underserved communities are still not back at the levels that we need them. To solve this challenge, we are focused on what we call a More Doors, More Dollars approach. This has allowed us to open up product lines to qualified community development financial institutions, and we have streamlined and simplified loan processes to increase small-loan volumes. At the same time, we are committed to aggressively protecting taxpayer dollars and ensuring that our programs are cost-effective. As I have testified before, we take a zero tolerance stance to fraud, waste and abuse in all of our programs.

Over the past 3 years, we have engaged in extensive review and redesign of SBA's lender oversight activities. At the core of this effort has been increased collaboration with our Office of Inspector General. One of the areas we identified early on is the importance of a strong oversight culture that is made possible through close coordination between the Office of Inspector General, our Office of General Counsel and key players across our loan programs. The results have been tangible.

For example, we have worked together to close more than 80 inspector general recommendations in the last year alone. To further increase the intensity of our oversight activities, we are incorporating best practices from our sister agencies, including FDIC, the Fed and the OCC, as well as private-sector financial institutions. We also sought out and incorporated feedback from SBA stakeholders, internal analysis, GAO reports, and advice and recommendations from members of this Committee.

Today we are seeing the results of these efforts, including more robust agency enforcement. Over the past 3 years, we have declined to renew delegated lending authority over 300 times for SBA lenders where the entities did not meet SBA's loan standards, and we have suspended or debarred over 50 loan officers, loan brokers, packagers and applicants in the 7(a) program.

We have also increased the activity of our Lender Oversight Committee, and we initiated a new Lender Supervision and Enforcement Task Force with the aim of originating enhanced supervision and enforcement actions. In addition, we are making significant organizational changes within our Office of Credit Risk Man-

agement, including the hiring of a new Director who brings a wealth of experience monitoring lenders, large and small.

In making these enhancements we have worked closely with our lenders and our stakeholders to address their concerns. In response to their input, we have simplified and updated our rules for lenders and borrowers, streamlined provisions of our loan programs, and are providing increased transparency in our lender communications and requirements.

We believe that these ongoing efforts to ensure consistency and clarity will further strengthen our ability to manage agency risks. All of these changes and enhancements flow from our three-pronged approach to manage risk, and I have mentioned this before: providing greater focus on preventing fraud or abuse before it happens; continual monitoring of loans in the SBA portfolio; and strengthening our enforcement function by punishing bad actors. This approach has been extremely successful in our efforts to root out fraud, waste and abuse in government contracting, and we are seeing similar results in lender oversight.

Thank you again for the opportunity to testify before you today. I look forward to working closely with this Committee to build on the significant progress we have made, and I am happy to take your questions.

Chairman GRAVES. Thank you, Administrator Mills.

We are going to start out with Mr. West.

Mr. WEST. Thank you, Mr. Chairman and Ranking Member. And, Administrator Mills, it is great to see you again.

You know, that is one of the big things that I would like to focus on is this idea of accountability and, you know, the transparency and refining and streamlining of the processes, but also the consequences thereof. You mentioned the 50 loan officers, brokers and packagers that were suspended or debarred in fiscal year 2009. Has that increased or decreased as we look in the last fiscal year or so?

Ms. MILLS. It has increased significantly.

Mr. WEST. Okay. And in the 347 lenders, when you look at this preferred lending program, do we need to get tighter as far as the criteria by which we are allowing people to be preferred lenders? Is this a program that we want to continue on if you have 347 that you had to—you know, did not renew their preferred lending status?

Ms. MILLS. We have, as I mentioned in the written remarks, done an extensive overhaul on how we assess our lenders, including looking at the criteria for their risk ratings, and we are using different criteria, more expanded criteria, including activity level, size of loan, actual changes in lender behavior, which turned out to be very important indicators, and on average we audit about 180 lenders per year. So we are really revising our entire risk-base reviews.

Mr. WEST. And I guess the "so what" to it all is you talked about punishment, consequences. Can you give us an idea of the specific things that—the ramifications of not being renewed or being debarred by the SBA? I mean, what really is going to hold people's feet to the fire so that we do have the access to capital that is nec-

essary for our small businesses, and we don't have bad actors, as you just talked about?

Ms. MILLS. We have put together a real intensive focus on both supervisory and enforcement actions. And we have a new Lender Oversight Committee and what we call our Lending Supervision and Enforcement Task Force, and they assess each of the circumstances and go through the proper procedures and figure out what the consequences are.

But I think the message is clear. We have a zero tolerance policy for bad actors, and we are going to make sure there are consequences.

Mr. WEST. Can we make sure that we can get that into the Code of Federal Regulations if those standards, criteria, whatever, are not there currently?

Ms. MILLS. We work with those that are there currently, and we now have great cooperation with our inspector general and the Department of Justice as well.

Mr. WEST. I have to be fair in asking this. We didn't grow the administration to have this new agency that you are talking about. I mean, this was in-house or what?

Ms. MILLS. We have reorganized in-house.

Mr. WEST. Then I am happy.

Thank, Mr. Chairman. I yield back.

Chairman GRAVES. Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you.

Administrator Mills, in an interview you gave to The New York Times in March, you stated that the gap in credit for small-dollar loans and loans to underserved communities was caused by the withdrawal of the big banks from the 7(a) program. You also stated that major effort is now underway to bring them back into the fold. Do you think this is a sound strategy given that these negative trends were caused in large part by an overreliance on a handful of large lenders to drive lending?

Ms. MILLS. Well, Ranking Member Velázquez, you are exactly right that this issue was caused by the fact that we had only a few large lenders making loans of the small-dollar variety, and in the credit crunch, they went away from the market, and they had been using consumer credit scores, and as a result they had made a lot of loans that turned out not to be very good.

Ms. VELÁZQUEZ. Do you recall in previous hearings where you attended and you participated in that I raised the same issue?

Ms. MILLS. Yes. And you have been very, very helpful and consistent on this, and as a result we have been focused on a number of solutions. As you mentioned——

Ms. VELÁZQUEZ. What is the strategy?

Ms. MILLS. There are three pieces to the strategy. We call it, as I said, More Doors, More Dollars. So the first strategy was in the community, whether you walk through the door of the local community bank or the CDFI, we wanted to make sure you had access to an SBA guarantee. We brought 1,000 banks from the community bank sector back to SBA lending, and then we opened the doors to selected community development financial institutions that had good lending records to be able to make 7(a) loan guarantees. But that was not enough.

Ms. VELÁZQUEZ. Isn't it true that most of those banks basically make one loan or were attracted by increased guarantee from the Recovery Act? Once that expires, they are gone. So what is your agency doing to recruit new lenders and support their lending efforts, particularly if they only make one or two loans a year?

Ms. MILLS. Once again, you are exactly right. The real bulk of these loans come from the large lenders, but we could not open up to the same procedure as we had before. So we have changed our process to use a different methodology called the Small Business Predictive Score, SBPS. It is a score used in lieu of the consumer credit score. We have incorporated this into our new processing of our Small Loan Advantage loans, because large lenders and regional lenders were not making small loans because it was too expensive for them. So we understood their processing issues, reduced their costs, and then instituted a more predictive score in order to make sure that the loss rates would not skyrocket.

Ms. VELÁZQUEZ. You know, in my opening statement I raised the issue that this economy is still fragile, and that the last report shows that the unemployment rate went up, and basically the companies that will be creating those jobs are new start-ups. And it is just like for 2 or 3 years now, since 2008, I have been raising the same issue. And since the JOBS Act increased the maximum SBA loan to $5 million, the percentage of smaller loans, defined as those of $150,000 or less, declined from 17 percent of total lending dollars in 2009 to just 8 percent.

So the jobs that we need to create, those companies and those start-ups are not getting the credit that they need, and I don't see that just by creating a new pilot program or a new program, lending program, that is going to reduce paperwork—SBA Express Preferred Lending Program, all of them reduced paperwork.

Ms. MILLS. We have launched a Small Loan Advantage Program June 1 with new procedures, and on day one we had 45 loans in the queue. This is a highly exciting product, a process improvement for our lending community. So we believe that this will be a very important augmentation for the problems that you just described, and we are going to continue to work on the start-up problem which you mentioned, which is also very, very important.

Ms. VELÁZQUEZ. Last year the Women's Procurement Program was finally put into place, and agencies began awarding contracts under this program in the second half of fiscal year 2011. However, contracting officers have not been really using this program. In the current fiscal year, there have been 143 actions worth $3.6 million.

So I would just like to ask you, since we passed this legislation, we went to court, U.S. Women's Chamber of Commerce went to court, the new administration promised it will have it up and running, and it has taken this long, my question to you is can you outline the steps that SBA and you specifically are going to take to educate contracting officers of their ability to set aside to women-owned small businesses?

Ms. MILLS. Well, I am happy to get back to you with a list of specific events and activities. We have a continuous program, and I personally am very committed to our women's contracting role.

As you know, this was passed by Congress in the year 2000, and we took it up and went through the entire process of getting it up

and running. And we have I believe it is close—I am going to get you the exact number, but I think it is 8,000 women who have self-registered in our contracting registry, and we now are active every day with every agency, because we have goals, and we are holding our agencies accountable for meeting those goals.

Ms. VELÁZQUEZ. Well, numbers speak volumes. $3.6 million have gone to women contracting awards. So all I can say is that women-owned businesses have been waiting for 10 long years, and they deserve better. Thank you.

Chairman GRAVES. Mr. Mulvaney.

Mr. MULVANEY. Thank you, Mr. Chairman.

Administrator Mills, thank you for coming today. I applaud your efforts regarding the smaller loans. It is something that we have seen both in this hearing room, but also as we have traveled the country. I know that Ms. Chu and I went out to her district and heard exactly this, that small businesses were having difficulty getting access to the smaller loans, and the numbers that you heard the ranking member mention about the size of those 150,000-or-less loans dropping from, I think, 17 percent to 8 percent is exactly what we are seeing in the real world. So again, on that front, I applaud you.

I guess my question is this: Other than you talked about bringing in some more community banks, which I think is a tremendous idea, because, again, we saw the same thing which you have just described, which is that fewer and fewer banks are actually doing this. You get to a bigger bank, the small loans don't make any money for them, so we have to figure out a way to fix this.

Beyond reaching out on this More Doors, More Dollars program, how are you actually physically changing the process? Give me specific examples of how you are making it easier for my local Camden community bank to make a $50,000 SBA loan?

Ms. MILLS. Well, we would be very happy to sort of walk you through the actual changes. We have reengineered our entire Small Loan Advantage, and this is what launched. Small Loan Advantage is actually a processing option for lenders, and it is under our 7(a) program, but it is designed to solve the problem that lenders have, which is making small loans wasn't affordable. They weren't making any loans because they weren't making any money making those loans. So we have recently implemented further streamlining, and the use of the Small Business Predictive Scores is a very important component of that, because it reduces the time to make the loan, and it has been proven much more predictive of success than consumer credit scores.

Mr. MULVANEY. I understand the change on that, but if I am a banker, and I used to do loan closings, I dealt with bankers all the time, and if I am a banker, one of the things I am interested in is the number of forms I have to fill out and the number of documents that I have to process.

Ms. MILLS. Well, we are happy to take you through them. They are much reduced. They are much more automated.

Mr. MULVANEY. Do you think it is more accessible now to community banks than it was a year ago?

Ms. MILLS. Absolutely. We have changed this format so that it is open to all lenders, not just our preferred lenders, and we have

a streamlined option. Lenders have the option of using their own notes, for instance, instead of using SBA notes, so that reduces the amount of paperwork.

Mr. MULVANEY. Is what you just described part and parcel of that program that went in on June 1st, or is that a different program?

Ms. MILLS. No, this is part of that June 1st revision.

Mr. MULVANEY. Well, good. I encourage you to continue to do that, because, like I said, what we have seen in the real world is that for small businesses, these things have dried up.

I have got a couple very quick questions to follow up on what Colonel West had asked about, which is the 50 loan officers, brokers, packagers that were suspended or disbarred; the 347 lenders that you took off of—you did not renew their preferred status. I recognize that that is 400 different circumstances, but do you see any general trends in the reasons why you are taking those actions? What are you seeing out in the field amongst the loan officers, for example? Are there general things that are happening that says, wait a second, this is one of the things we need to—reasons to get rid of these folks?

Ms. MILLS. Well, that is a very good question, and I think once again I would like to get back with you on the details. But we know now that we have a whole series of indicators, and we are incorporating those learnings. We know, for instance, lender behavior is a very important indicator. When loans start to go up very, very fast, it is an important time to look at a lender and dig deeper and perhaps do a more risk-based audit. So we are using those criteria, and we can show you what they are.

Mr. MULVANEY. Great. Thank you.

And then finally, last question on the budget, and I apologize for being the budget person. The budget this year did not request an extension of the commercial refinancing program in 504. Why was that?

Ms. MILLS. Well, the commercial refinancing program in 504 has, in fact, been quite a successful program in the last year, and it has allowed small businesses to refinance mortgages and use some of that capital as working capital, which has allowed them to grow and create some jobs. It does expire at the end. It is not authorized to go forward. But I will point out that it has picked up steam, and there is a lot of people out there who like it.

Mr. MULVANEY. I yield back the balance. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

Well, it was a popular program. Why is it not being requested to be reauthorized, though? I guess that is the question, following up on the Representative's point, because it is tough for small businesses to get access except through that creative program you developed.

Ms. MILLS. Right. Well, this is a very good question, and it is something that has come up before Congress in a number of ways and a number of times and has not yet been reauthorized.

Mr. SCHRADER. So you wouldn't be adverse to us suggesting it be reauthorized, I guess is where we are going with that.

Ms. MILLS. It certainly has a lot of success right now in the marketplace.

Mr. SCHRADER. I want to congratulate you on some of the great work on the delinquency stuff. Since the new sheriff, if I may refer to you that way, is in town, the delinquency rates for 504 and 7(a) have gone down very dramatically, and it looks like the attention on getting good-quality loans out there is being met. So I appreciate that access.

How about what is the situation for capital? At the end of each cycle, it seems like SBA, even Rural Development, for that matter, the capital gets drawn up quickly and inability to make loans because of insufficient capital. Where are we right with SBA in terms of capital so that you can make the loans you want to make?

Ms. MILLS. We have room in our authorization to make all the loans, large, small, medium-sized, that we need to make.

Mr. SCHRADER. Good, good, good.

And then historically we have had problems with our HUBZone programs and some of our veterans programs where certain unscrupulous people take advantage of them, and you, I know, have had your attention on them. Can you comment a little bit as of recently here, this month, how we are doing in terms of curbing some of the ne'er-do-wells and their taking advantage of programs they shouldn't have access to?

Ms. MILLS. Well, as I said, we have a zero tolerance policy for fraud, waste and abuse, and we began our effort with our government contracting programs and with particular regard to HUBZone. We have three pieces of that, which is up-front certification, ongoing monitoring, and going after bad actors.

In HUBZone in particular we completely redid the up-front certification and now have a streamlined, effective process for HUBZone certification. So we are working very hard. We are always improving processes. But that major hurdle that we have has been successfully moved forward.

Mr. SCHRADER. We haven't had a GAO report since then, I guess, to establish how well it is doing, I guess, at this point in time, but you feel confident you would survive much better than we have in the past an a result of the changes you made?

Ms. MILLS. Yes. We take an ongoing look, and we do not take our eye off the ball on those government contracting problems.

Mr. SCHRADER. One of the other issues that comes up a lot, and I don't know how much control you have over it, is that with some of the minority women contracting issues, some of these firms develop to become firms to take advantage of that program, and the real small businessmen and women don't actually get these contracts at the end of the day. They go out to larger firms that purport to subcontract this out. A lot of times it is out of State, small businesses. Is that something the agency is focused on at all?

Ms. MILLS. We are absolutely focused on making sure that the program benefits go to those who are qualified to receive it and for whom it is intended.

Mr. SCHRADER. Excellent. Excellent. Good. Good.

And then again following up on some of the questions that have been asked, does SBA have particular improvements in some of the timelines you alluded to, you know, timelines as far as getting a

loan application to resolution; the difficulty sometimes of getting these loans, the paperwork notices we heard over the last 2 or 3 years? Are you tracking that sort of data, getting it done quicker, better?

Ms. MILLS. Yes. We absolutely track our turnaround times, and they range in the 10- to 20-day turnarounds. And we have made significant improvements over time, and we have a dashboard where we know where it is weekly.

Mr. SCHRADER. That is an improvement. What was it when you came in, if I may ask?

Ms. MILLS. Oh, it was significantly longer.

Mr. SCHRADER. That data would be good. I think you should use that data to talk about some of the turnarounds that have occurred since you have taken office.

I appreciate your attention on all the—you know, quite frankly, the agency had been, in my opinion, in some disarray and not well funded, not well appreciated, and as has been pointed out, there is still a big lack of capital for really smaller businesses.

So I hope—one question on that I guess, I have got time. You are doing well, I am doing well. What about rural lending? That is another issue that we are concerned about. It seems to have fallen off a tad, and obviously I want to make sure that rural America responds, too.

Ms. MILLS. I was just in West Virginia. Next week is our first anniversary of some of the things we announced for rural America. We are very focused on making sure that we have an inclusive strategy for entrepreneurs all across the country; that it is not just on two coasts, even though we like the coasts, because we see there are tremendous innovative entrepreneurs, even very technical entrepreneurs, in all kinds of rural areas, and they don't have as much access and opportunity.

So we have cultivated regional banks, community banks, credit unions and other lenders to make sure that they are using these new products, and we are also focused on it in our SBIC, where we did special focus on rural small business investment companies.

Mr. SCHRADER. Thank you very much. I yield back.

Chairman GRAVES. Ms. Herrera Beutler.

Ms. HERRERA BEUTLER. Thank you, Mr. Chairman.

I actually only have—you know, I have taken in everything that is being talked about, and I have a couple questions that are a little bit more specific, and I was hoping to get your comments on them. Obviously you can't speak to a specific case, but I wanted to share kind of some feedback with you.

I had a printer in the largest county in my district who was working with a lender to apply for a SBA loan, and he said—this was at a town meeting. He raised his hand and said, it is very frustrating and time consuming, so obviously we wanted to know a little bit more about it.

So this is what happened. The local bank took the application and then came back to him and said that the SBA asked for more documentation, which he provided. He jumped through those hoops. In the meantime, the bank gave him a line of credit while they were kind of going through this process, and which obviously later termed out at a very high interest rate. He later found out

that the bank never presented his application to the SBA. And I was very, very curious about how much leeway these banks get in picking and choosing what loan applications they pass on to the SBA and what you are doing to improve oversight in instances like this, where someone thinks they are in good faith doing—and the printer is still operating today. It is not like it was some fly-by-night operation, right? It was a good-standing business in the community and still is.

Is this common to hear something like this?

Ms. MILLS. Well, first of all, I appreciate your having brought this to our attention. You know, it is what we do every day to follow up on small businesses that need access and opportunity, whether it is to loans, or contract, or counseling or other help. So we are always happy to have our people go see what we can do to help them.

In this particular case, to answer your general question, we have a public-private partnership between the Federal Government and banks, and that makes for a very cost-effective program. So banks are supposed to make all the loans that they can without the SBA's help, because if the market will provide credit, then why should the taxpayer subsidize that?

But there are lots of instances, as we know, that small businesses don't meet the credit standard, but they are still good, and the bank would like to make the loan, they just need a little help. That is where they come to the SBA for an SBA guarantee. So it would need to meet the criteria that the bank could not make this without the SBA's help.

If the bank—the other thing I would say to your small business is when you are preparing for a loan, you should come to one of our SBA small business development centers and get a mentor and a counselor to help you work through your business plan and your bank package. It tends to make for a more creditworthy conversation when you get to the bank, and they can help direct you to a bank that is interested in that particular industry.

Ms. HERRERA BEUTLER. Well, and that makes sense. However, if you are using the bank or banks as your partners, and they are kind of an entry point, so to speak—and I get it, you know, if you can make a loan in the private sector, go for it, right? That is mostly what we want. But this is during the credit crunch when small business lending, SBA was really the only game in town. So here this borrower thought he was dealing with the SBA and jumped through the hoops to comply with what he thought was SBA paperwork. It seems somewhat disingenuous for a lender to then say, yes, yes, we are hoping to get there, hoping to get there, and you will just do the loan through us, and it is a high interest rate, and SBA isn't involved.

Is there some sort of a regulatory guidance? I mean, I understand that you guys are overseeing the loans that you have made, but at what point is someone paying attention to the partners and making sure the partners are following SBA policy? Does that make sense?

Ms. MILLS. Well, we pay tremendous attention to the partners and make sure they follow SBA policy. And the banks in this situation, we would be happy to follow up with you further, but I want

to assure you that there are strict SBA policies, and one of which is that they need to make a determination that it is a credit—it is an SBA situation.

Ms. HERRERA BEUTLER. So do they let the potential perspective borrower know at some point, yeah, you came here for a SBA loan, you are filling out SBA paperwork, but this is going to be a conventional loan through a bank? I mean, is there any kind of a requirement that they up front say, okay, you are not going—it is not going to be SBA credit, we are going to kind of walk you through this process?

Ms. MILLS. I would be happy to get back to you with the specifics on the guidelines on that specific communication. We can get back to you.

Ms. HERRERA BEUTLER. Well, not only just this case though. I mean, in general do they have to at some point say, hey, you are dealing with us, the bank, not us, the SBA partner? Do you require that?

Ms. MILLS. I am happy to go through the specific guidelines to answer that question, but in general, yes, the bank does say, this is a loan from us; or the bank says, this is a loan from SBA. And the paperwork would reflect it is a loan from the bank or a loan from the SBA.

Ms. HERRERA BEUTLER. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Owens.

Mr. OWENS. Thank you, Mr. Chairman.

Thank you for coming to testify today, Administrator Mills.

We have had a lot of conversation and questions about credit availability, and you just described in response to a question the fact that primarily you want the banks to do the lending; secondarily, you want a form of guarantee program; thirdly, you would have a direct loan from the SBA. Would that be a fair ranking of those?

Ms. MILLS. No, sir. Let me clarify.

First, the marketplace provides 90 percent of the lending to small business. The role of the government guarantee is to provide additional access and opportunity when the bank won't make that loan. We do not have a direct lending program except in our disaster loan operations.

Mr. OWENS. Okay. Now, there does come a point, and we did hit that in 2008 through 2010, where the SBA has to make a decision about a guarantee as to the creditworthiness of the borrower, and in many instances what occurred during that period was that creditworthiness would not meet your standards, and therefore the guarantee was not issued. Would that be a fair statement?

Ms. MILLS. Well, we have a process where a bank will make a decision about whether they want to make a loan or whether they want to make a loan with an SBA guarantee. In certain cases that authority is delegated to lenders to make that decision, and in other cases where we have not granted delegated authority, it comes to our processing centers for credit review.

Mr. OWENS. And there are times, obviously, when you make a determination that the borrower is not creditworthy.

Ms. MILLS. That would be correct.

Mr. OWENS. And that accounts for some of the declinations in the loan process; in other words, they were declined a loan because they were not creditworthy?

Ms. MILLS. Correct.

Mr. OWENS. You also talked a little bit about this predictive score, and I would like to hear a little bit more about that, exactly how you operate it and what the source of that analytic is.

Ms. MILLS. So the Small Business Predictive Score has been around a long time. It is used throughout industry, and, in fact, we have had it for quite a bit of time analyzing our portfolio. But on the front end of the portfolio, the standard had been for many banks in 2005, 2006, 2007 to use consumer credit scores as a cutoff. We have a lot of legacy defaults from our 2005, 2006, 2007 portfolio. In fact, that is a substantial part of our subsidy cost.

When we looked going forward, we have begun to make a new analysis of our credit thresholds as part of this entire look at credit risk management, and what we have found through extensive analysis is that this commercially available, widely used industry standard product, the Small Business Predictive Score, is a much better predictor than the consumer credit score. So we have now begun to incorporate it even more significantly in the front end of the credit process.

Mr. OWENS. And that analytic you indicated is an industry standard. I am assuming you mean the commercial lending industry?

Ms. MILLS. Correct.

Mr. OWENS. So you are taking something from the private sector and incorporating it into your analytics in making your decisions?

Ms. MILLS. Right. But this is something that we have had access to and is part of our system, and we have been using it more on the back end than on the front end.

Mr. OWENS. Thank you. I have no further questions.

Chairman GRAVES. Mr. Landry.

Mr. LANDRY. Thank you, Mr. Chairman.

Administrator Mills, I wanted to ask you a question about a correspondence that I sent to you back in October of last year concerning HUBZones, and it is just a kind of basic question, because I sent the letter to you all, and the response I got did really not suffice. It didn't answer the question.

Could you tell me what the current status of the HUBZone program following that recalibration is? I mean, I had three parishes or counties in the district that were removed from the HUBZone, but the calibration was being done at a time when the Deepwater Horizon incident was affecting our economy. And my question to you all, which has not been answered, is whether or not the economic—if you all used the economic data or looked towards the effects of the government-imposed moratorium on my district, and specifically those comments, because they are on the gulf, if that impact was used when recalibrating their position?

Ms. MILLS. Well, number one, I want to tell you straight out that we will go back and take your original letter and any additional thoughts or questions or clarifications that you would like and spend the time to make sure that you have a full answer.

Mr. LANDRY. Thank you.

Ms. MILLS. We want to make sure that we spend that time and have you be satisfied with the response.

The HUBZone program is right now designated by census data as to what is a HUBZone, and we had some new data, so we have new HUBZones and new maps. And we want to make sure—we will follow up with you after this meeting to make sure that we understand specifically how that affected your counties that you mentioned.

Mr. LANDRY. Right. And that is the only question that was left unanswered was just the fact that when you took the census data prior to the Deepwater Horizon incident, we were experiencing an economic upturn; however, the administration created an economic downturn due to the moratorium. So I just thought that it would be fair to calculate that amount in there, and I just would ask that you all take a look at that to see if there is anything we could do to determine whether or not that data would put them back into the HUBZone status.

Ms. MILLS. Yes. We would be happy to.

Mr. LANDRY. Thank you, Mr. Chairman. I yield back.

Chairman GRAVES. Mr. Critz.

Mr. CRITZ. Thank you, Mr. Chairman.

Thanks, Administrator Mills, for being here. It is good to see you again, and our walk through Vandergrift was very nice. We got a lot of good feedback from that.

My first question is I had a field hearing in Pittsburgh earlier in the year in April, and it was about small businesses engaging in international trade, and many of them discussed the critical role that credit and capital play for companies operating in foreign markets, but they don't know that the SBA is a viable option.

My concern is that district offices are cut to the bone, and I am wondering how the agency can better market itself so that exporters are made aware of SBA's trade financing programs. And what brought this to light is that I guess in the past year, nearly three times as many export loans have been made by the Ex-Im Bank than through SBA to small businesses. So I am curious why the SBA is lagging behind, and what do we need to do to market it?

Ms. MILLS. Well, first of all, you are exactly right that there is tremendous opportunity in export. And I am happy to get you the exact statistics on it, but I assure you there has been tremendous growth in the SBA export loan program this year, actually record growth, and also in our export counseling.

But I want to point you to our STEP grants, which are the vehicle that we have been given by Congress to get even more impact in a State-by-State basis. This is $30 million a year, funded for 2 years, to give competitive grants to State export offices to work explicitly on small business exporting. And this ensures that our district offices, the State offices and any other players are acting in a coordinated fashion on the ground so that we make the best use of the buck.

Mr. CRITZ. Well, good. Good. Thank you.

The second question is just over a year ago, SBA implemented a Small Loan Advantage pilot program, which delegated authority to current SBA lenders to make loans based on basically the two-page application. In the past, efforts to reduce paperwork and dele-

gate authority have led to dramatic increases in default rates. What safeguards are in place to ensure that this new effort does not facilitate poor underwriting decisions or ultimately increase the cost of the 7(a) program?

Ms. MILLS. As I was mentioning earlier, the Small Loan Advantage 2.0 is a processing option for lenders under our 7(a) program, and it has been recently improved and streamlined further and opened to nondelegated lenders. And that went into effect June 1 with very strong response from the lenders. The safeguard that you described is the use of the Small Business Predictive Index at the front end of that new processing.

Mr. CRITZ. Okay. Thank you.

Well, the Committee is well aware of the economic slowdown or what the impact of the economic slowdown had on SBA's lending portfolio, and we worked hard to provide SBA tools to bring lending volume back to preslowdown levels. I also think it is important that you have to walk that line between providing small businesses capital while protecting the taxpayers' money.

Can you tell us the current state of that portfolio, and can you describe also the creditworthiness of SBA's lending portfolio?

Ms. MILLS. Yes. If you look at my written testimony, on page 5 there are two graphs that describe the state of the current portfolio. In terms of delinquencies and purchase rates, they peaked in the final quarter of fiscal year 2010, and they have been steadily declining since, and they are at about the prerecession levels at the moment.

The second graph is the Small Business Predictive Scores over time, which is an indicator of the creditworthiness of the portfolio, which, as you can see, is improving.

Mr. CRITZ. Well, very good. Thank you very much. I yield back.

Chairman GRAVES. I have a question that is kind of outside, I guess, the SBA's portfolio. But we are hearing from banks, from a lot of banks, that they are having a hard time lending to small businesses because of the scrutiny by the regulators when it comes to small business loans.

Just out of curiosity, in your position on the Cabinet, can you use that? Because we can't seem to have any influence whatsoever over the regulators, and they don't want to hear from us, and it doesn't make any difference anyway. I mean, advocating for small business certainly, advocating for—you know, we have got to use a little bit of common sense here, and that scrutiny is really having some issues out there. At least the banks are telling us that. So can you use that position to push the Fed along a little?

Ms. MILLS. Thank you, Congressman Graves.

We have seen exactly the same concern, and I have, in fact, had conversations with regulators on a consistent basis, because it is a real issue if the guidelines that are given out by the regulators are not interpreted in a clear and precise way all the way down into the regions, and that creates uncertainty at the banks as to how a loan would be classified, and that makes them not willing to make the loan. And this is a matter, as you describe, of constant concern, and I take it as part of my job to continually have this conversation with the regulators.

Chairman GRAVES. That is good, because advocacy is obviously one of the—is an important part. It is outside your portfolio, but it is obviously very important.

Mr. Richmond.

Mr. RICHMOND. Thank you, Mr. Chairman and Ranking Member, and thank you, Administrator Mills, for coming in.

I guess I will start where the chairman just left off. It just so happens I was visited by some of my constituents today who we normally don't view as small business owners. But I had a meeting with my homebuilders, and they were talking about the crunch that they have accessing capital in order to build homes. And one of the things they mentioned was that before the regulations and some other things, that if they had a signed purchase agreement from a person, the person was already prequalified for the mortgage, that they could take that and almost use that as security to get a loan. And they said in those instances they didn't have—to their knowledge in the room, and I guess there was about 15 to 20 homebuilders—that in their recollection they could only remember one or two that didn't go right.

So I told them that I would pose that question to you: Is there something that the SBA can do specifically for homebuilders, or if there are any programs that you know of right now that they qualify for that they may not be paying attention to?

Ms. MILLS. Well, my father-in-law was a homebuilder, and I know exactly the situation that you are describing. What we will do is come back to you with a specific thought and recommendation on which SBA loan program or activity or banking relationship might be the most appropriate to pursue.

Mr. RICHMOND. This question shifts away, but it goes back more to the New Markets Tax Credit Program and our CDFIs, which, in my opinion, are working very well, especially in our inner cities and low-income communities. And I guess this question would be whether there is a way or if you have someone looking at ways to facilitate the 7(a) lending program with the CDFI program for low-income communities. That way they can benefit both from the tax credit and the 7(a) program.

Ms. MILLS. Well, thank you, Congressman.

As you know, over a year ago we implemented a program called Community Advantage, which allows selected CDFIs which have a good track record in managing loans to have access to the 7(a) loan guarantees. So that would be the primary vehicle that we use to engage CDFIs, which we think are really important new partners for us.

Mr. RICHMOND. One of the ideas that came from someone in my district was that if you all contemplated allowing CDEs to participate in the Community Express loans, and that way the CDFIs would be able to attract more small businesses investing into the New Markets Tax Credit Program.

Ms. MILLS. I would be happy to get back to you on that.

Mr. RICHMOND. Okay.

Administrator Mills, I don't have any specific additional questions for you. Do you have anything that—I will give you my last minute and a half if there is something that you just want to volunteer something that came up that you want to address.

Ms. MILLS. Thank you, Congressman.

Mr. RICHMOND. With that I will yield back, Mr. Chairman. Thank you.

Chairman GRAVES. Mr. Cicilline.

Mr. CICILLINE. Thank you, Mr. Chairman and Ranking Member, and welcome, Administrator Mills. It is good to have you back before the Committee, and thank you for your visit to my home State. The small businesses in Rhode Island enjoyed having you there, and it was a great opportunity to talk about the work of the SBA, and I thank you for doing that.

What I wanted to ask you about briefly is the SBIR program, which my State has had considerable success with. In preparation for this hearing, I reached out to the individuals in my regional SBA office, as well as folks in the knowledge economy that is growing in Rhode Island in the research and development community. And what I heard from so many of them was that this program is successful, it is vital, it has led to a lot of innovative companies conducting business in our State, but that we just don't have enough participation.

And one of the things that I proposed during our reauthorization was the FAST program, really which I think was the successful way to do outreach to encourage participation in the SBIR program by providing grants to organizations that do that. And I know we didn't include it in the authorization, and I am wondering sort of what strategies that you are developing to really broaden the reach of SBIR, which is such a good model and such a successful program.

But while I am very proud we have had more than 290 awards and more than $100 million in grant funding in Rhode Island, which has been great under the SBIR and STTR, I think there are 39 States ahead of us, so it seems to me there is a lot of untapped opportunity. But without the FAST program, are there other ways that you are thinking about or that we can support broader outreach for this program?

Ms. MILLS. Well, first of all, I want to thank this Committee and Congress for the reauthorization of SBIR and STTR and for your commitment to it. We are working very hard on SBIR, and one of the things that I want to point out is that we have consolidated all SBIR solicitations, which used to be on 11 different agency Websites, into 1 Website, SBIR.gov, and educating all of our various arms and counselors and partners to make sure that they mention and inform people about SBIR so that we have a broader network.

With regard to FAST, my understanding is that although it was not extended the reauthorization package, Congress could extend it through appropriations as they have done in past years.

Mr. CICILLINE. And I take it you would recommend that we do that?

Ms. MILLS. Well, as I said, it is a very—the SBIR is a very important program. We are working very hard to make sure that in every aspect of Small Business Development Centers and our counselors, district offices and advisers that we incorporate knowledge about SBIR in our conversations with small businesses.

Mr. CICILLINE. Thank you. And I just have one other area. You said this in the beginning of your testimony. I arrived a little bit late, and I apologize, and I am happy to get some information after the hearing. But would you just talk a little bit about the Service-Disabled Veteran-Owned small business program and the status of that? This is an issue of considerable concern, I know, to many Members of Congress in ensuring that we are doing everything we can for service-disabled veterans, and this program obviously is designed specifically for that.

Ms. MILLS. Yes. We have a number of programs for service-disabled veterans, including our contracting program which you are referring to. But we also have some really extraordinary counseling, advice and veterans entrepreneurship education programs, some of which are particular to service-disabled veterans. So those are critical as well, and we can make sure you have more information on those.

Mr. CICILLINE. Thank you.

I yield back, Mr. Chairman.

Chairman GRAVES. Ms. Clarke.

Ms. CLARKE. Thank you very much, Mr. Chairman. I thank you, Ranking Member. And I join my colleagues in welcoming Administrator Mills back to our Committee.

Administrator Mills, while I understand the concerns of my colleagues, I echo a lot of what has been said here today. I would like to switch gears slightly.

As we have discussed previously, MWBE small businesses face an uphill climb in the best of times. While our economy is still recovering, and we all understand that events outside of the United States' control, including the cooling of emerging economies, the eurozone crisis, which are currently contributing factors, the most recent economic data is anything but encouraging.

That being said, if we find ourselves in a situation where capital access finds itself even more constrained than it is currently, what is the SBA prepared to do with regards to perhaps a greater need amongst the small business community and especially within the minority small business community?

Ms. MILLS. Well, Congresswoman, we have had a lot of this conversation, because you, like many members of this Committee, have been concerned about this for some time. And, as you know, we share this concern, because although lending overall came back strong to the SBA, it did not come back strongly for small-dollar loans in underserved communities.

So 2 years ago now, we began a series of activities that, as I mentioned, we call More Doors, More Dollars, and they include the bringing in of CDFIs, the bringing in of faith-based institutions. And they include something else, which is an outreach program we did called the White House Urban Economic Forums. And my colleague and deputy, Marie Johns, and I have been—she has been particularly active traveling the country and in many, many cities dealing with over 2,500 in-person participants, 800 mentoring relationships facilitated, 23,000 on-line viewers, directly trying to reach and access this women- and minority-owned business community so that we can find a way to connect them to what they need, which

can be contracts, it can be loans, it can be help and advice, so that they can grow their businesses.

We have an inclusive view of entrepreneurship, and we need to be working to make sure all our entrepreneurs have access and opportunity.

Ms. CLARKE. Well, let me ask a second question of you. We have discussed the fact that some SBA programs haven't lived up to their charter, and while I applaud the SBA's willingness to address the shortcomings of certain programs, what processes are the—is SBA putting in place to ensure that future newly configured programs are living up to their charters and don't require the overhaul that Community Express did, for instance?

Ms. MILLS. Well, we are very actively monitoring and assessing and working on continuous improvement of all of our programs.

Ms. CLARKE. Well, I would have no doubt that you will keep your finger on the pulse of these new ventures.

I want to also echo the sentiments of Congressman Schrader about the HUBZones and the usage of women- and minority-owned businesses to get the contracts, and then the discarding of those companies when the contracts are awarded. That seems to be a very hard nut to crack on many levels, but I hope that vigilance is used to address this.

And perhaps there needs to be some examples made of some of these companies that have been doing this so that, you know, in the future others won't see this as a means of accessing the contracting opportunities that are supposed to be partnerships, quite frankly. And I think that this could be a gateway for more employment in communities that are having a hard time coming back, because now you are, you know, opening up the landscape a little bit more for opportunities that didn't exist previously.

Ms. MILLS. Well, let me repeat that on HUBZone, and really on all of our contracting and lending operations, we have intensified our supervisory and our enforcement activities, and we have a zero tolerance policy for bad actors.

Ms. CLARKE. Very well. Thank you.

I yield back, Mr. Chairman.

Chairman GRAVES. Ms. Velázquez.

Ms. VELÁZQUEZ. I don't have further questions.

Chairman GRAVES. Before we finish up, I want to echo Mr. Schrader's concerns with the rural loans or the decrease in rural loans and the outreach there, and would push for a little bit of outreach out there, because they are just as important in the rural areas as anywhere.

But I would like to again thank you for coming in today and for being here to discuss, obviously, this very important issue of capital access for small businesses. We know on this Committee that they are going to lead us out of the economic downturn and into the economic recovery, and we want to continue, obviously, to be very vigilant in overseeing the programs that you administrate.

With that, I would ask unanimous consent that Members have 5 legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

[The information follows:]

Chairman GRAVES. With that, the hearing is adjourned. Thanks again.

[Whereupon, at 3:22 p.m., the Committee was adjourned.]

U.S SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

TESTIMONY OF
**ADMINISTRATOR KAREN G. MILLS**

BEFORE THE
HOUSE COMMITTEE ON SMALL BUSINESS
**JUNE 6, 2012**

Chairman Graves, Ranking Member Velázquez and members of the Committee – thank you for inviting me to testify on the SBA's lender oversight program.

As I have said in previous testimony before the Committee, this Administration takes a "zero tolerance" stance on fraud, waste, and abuse in each of our programs, including our 7(a) and 504 loan programs. In the wake of the financial crisis and corresponding downturn in the general economy, this Administration has brought a new intensity to how we approach lender oversight.

Over the past three years, we have engaged in an extensive review and redesign of SBA's lender oversight activities. This has led to several changes to our lender oversight program, including enhanced supervision and more aggressive enforcement against problem lenders, loan agents, brokers and packagers, and loan applicants.

Much of the progress we have made in our oversight efforts has been accomplished through improved collaboration and communication with our Office of Inspector General (OIG), which is led by Peg Gustafson. One of the many things Peg and I identified early on is the importance of a strong "oversight culture" at SBA and the implementation of best practices used by other agencies and financial institutions. I also should note that many changes we have implemented are in line with recommendations made by the OIG and the Government Accountability Office (GAO), as well as members of this Committee.[1]

**Key Drivers of Lender Oversight Changes**

To begin this process of revamping our lender oversight, we commissioned a third-party study to assess our processes, organizational structure, and our risk analytics. In addition, we engaged our sister agencies that conduct lender oversight programs of their own—including the Farm Credit Administration (FCA), the Export-Import Bank (Ex-Im), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Fed), and the Office of the Comptroller of the Currency (OCC). These agencies are sharing with us their best practices on a number of oversight topics, including the importance of establishing a comprehensive risk plan for the Agency, which identifies the factors the organization will consider in evaluating acceptable risk parameters for the SBA portfolio and the lenders that underwrite SBA loans. SBA expects to complete its first comprehensive risk plan before the beginning of the next fiscal year and will issue updated plans annually thereafter.

[1] SBA has closed 80 OIG recommendations spanning 25 audit reports, and SBA believes the changes being made within OCRM will help close several more.

Finally, over the past several months, we have listened to feedback from our lending partners. In general, they have asked us for greater clarity, consistency, and transparency in a number of lender oversight areas. We are incorporating this feedback into our lender oversight program.

The study findings, best practice sharing, stakeholder feedback, and our own internal analysis are driving the changes we are making in our Office of Credit Risk Management (OCRM). The focal points of these changes fall into four key areas: (1) organizational changes within OCRM; (2) process improvements to our Risk Based Reviews (RBRs)—the periodic assessments of an SBA lender's management operations and controls; (3) improving OCRM's risk analytics—the methods we use to assess the risk that a loan or lender poses to our portfolio; and (4) more robust Agency supervisory and enforcement mechanisms.

**Organizational Changes**

In terms of organizational changes, earlier this year we brought on a new OCRM director, who brings a wealth of experience monitoring lenders—both large and small. He served eight years with the FCA, and more recently he spent six years at the FDIC. He has already met with Congressional staff several times to share his insights and obtain feedback, and we would certainly welcome and appreciate any additional guidance you or your staff may have on the topics we are discussing today.

In addition to management changes, we are taking steps to realign OCRM's structure to reflect our increased emphasis on enforcement, transparency and accountability. This is highlighted by important shifts in how oversight will be conducted—both geographically and institutionally. OCRM will adopt a regional approach to supervision, which is used by the FDIC and OCC. This will allow for more precise assessment of banking and business lending activity by economic region, much like that of the Fed. This new structure will be complemented by a shift toward tailored RBRs for each of our three primary lender groups: 7(a) depositary lenders, Certified Development Companies (CDCs), and 7(a) non-depository lenders. This realignment will allow us to move away from the previous "one-size-fits-all" approach to our portfolio and the lenders that comprise it, and puts us more in line with industry best practices.

Following a recommendation in the third party study, we are also in the process of creating a quality and standards unit to, among other things, develop lender and loan benchmark metrics. This new unit will help anticipate and identify problems before they occur.

**Changes to Risk Based Reviews**

Many of our lenders recommended that our RBRs should be redesigned for more targeted portfolio assessment. Our shift towards institutional tailoring addresses these concerns.

Also, in the past, OCRM placed heavy emphasis on lender characteristics such as the size of the SBA portfolio. However, recent data, trends and best practices indicate that lender behavior triggers are also significant in determining our monitoring activities. As a result, our new risk-based portfolio approach will also include critical lender behavior factors, such as high loan volume growth and a lender's secondary market exposure. We have received a positive response to these proposed changes from the SBA lending community.

**Improvements to SBA's Risk Analytics**

The third party study, as well as our internal analysis, found that while the data we collect through a variety of sources is robust, there are more effective ways to use this data. As a result, we are working to enhance OCRM's processes and platforms in order to better leverage our data.

For example, we determined that SBA's risk data warehouse should be oriented toward one unified data portal for consolidated lender information. This means leveraging the portfolio data by sharing it with the proper offices and individuals to ensure consistency across the board in our loan programs. This not only improves our ability to properly manage risk, it also provides our lending partners with greater clarity as they monitor their own SBA portfolios.

OCRM also will be expanding the use of data analysis in determining which SBA lenders will be required to undergo an RBR. By making our RBRs more targeted, we will optimize the staff and budget resources needed to perform the reviews.

We are also engaged in ongoing discussions with the FDIC, OCC and the Fed to improve our data sharing capabilities. This will help us avoid unnecessary duplication and improve the effectiveness of our portfolio monitoring efforts.

And finally, the lender risk rating model we developed in cooperation with Dun & Bradstreet is being reviewed and updated. This effort was guided in part by the findings of a GAO report, which found that our risk rating information was adequate, but the way OCRM utilized the data required strengthening.

**Higher Intensity Oversight and Enforcement**

The fourth area of emphasis involves more robust enforcement of SBA's lending requirements, including more timely corrective actions and, where appropriate, the non-renewal or revocation of a lender's SBA loan authority. This has been the topic of several OIG recommendations, and it is an area where we are taking aggressive action as part of the enhanced collaboration between the OIG and our Office of General Counsel (OGC). These actions are focused on overseeing lenders and CDCs that exhibit increased risk behaviors like a downgrade in the lender's "risk rating," higher risk portfolios, or repeated non-reporting and errors. These behaviors, in turn, may lead to enhanced SBA supervision and enforcement actions.

Over the past three fiscal years, we have declined to renew delegated lending authority 347 times for SBA 7(a) lenders and 7 times for CDCs in our Accredited Lenders Program where these entities did not meet SBA loan program requirements. Working closely with the OIG and our OGC, we will continue to aggressively pursue problem lenders and actors. For example, since FY 2009, we have suspended or debarred over 50 loan officers, loan brokers, packagers, and applicants in the 7(a) program.

And we are continuing to ramp up our oversight and enforcement activity: First, by creating an enforcement unit—the Lending Supervision and Enforcement Task Force (LSETF)—which is a partnership between OCRM and our OGC to develop and propose enhanced supervision and

enforcement recommendations; and second, by bringing, as appropriate, such recommendations to the Lender Oversight Committee (LOC) for consideration and action.

The LOC provides independent oversight for supervision and enforcement efforts undertaken by OCRM. It is chaired by SBA's Chief Operating Office and has two other voting members, our Chief Financial Officer and our Associate Administrator for Capital Access. The LOC also includes several senior Agency managers, who are non-voting members.

**Goals and Challenges**

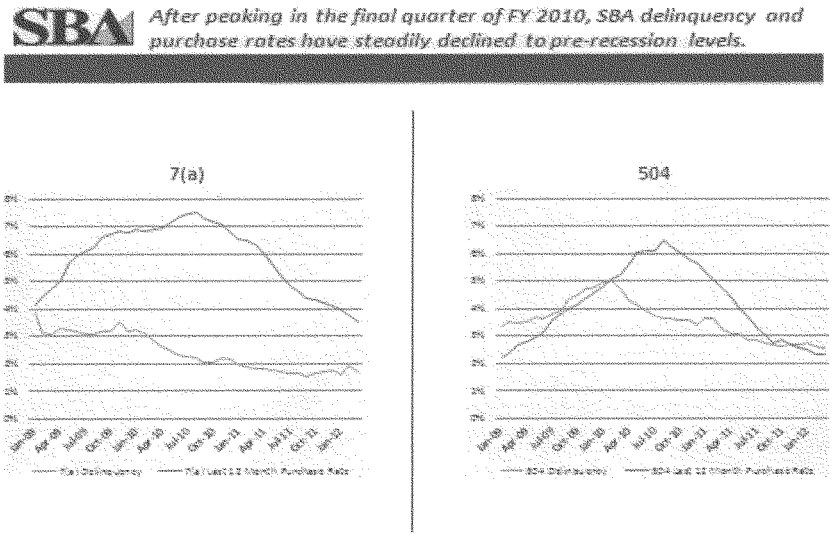
The goals of our oversight changes are twofold: ensuring that our loans benefit only the small businesses for which the lending programs are intended, and protecting the taxpayer dollars that support our loan programs. We believe we now have the tools and structures in place to more effectively achieve both goals. But there are some obstacles that we must overcome.

One challenge we are currently facing in our effort to improve our lender oversight program is the "stratification" of our current portfolio. Like the private banking industry, SBA organizes its loan portfolio into cohorts. Generally, SBA divides these cohorts into two broad portfolio categories separated by the recession: the legacy portfolio—loans made before 2009—and our emerging portfolio, which is comprised of loans made after the depths of the recession in 2008. We are finding that our legacy portfolio presents different risks than our emerging portfolio.

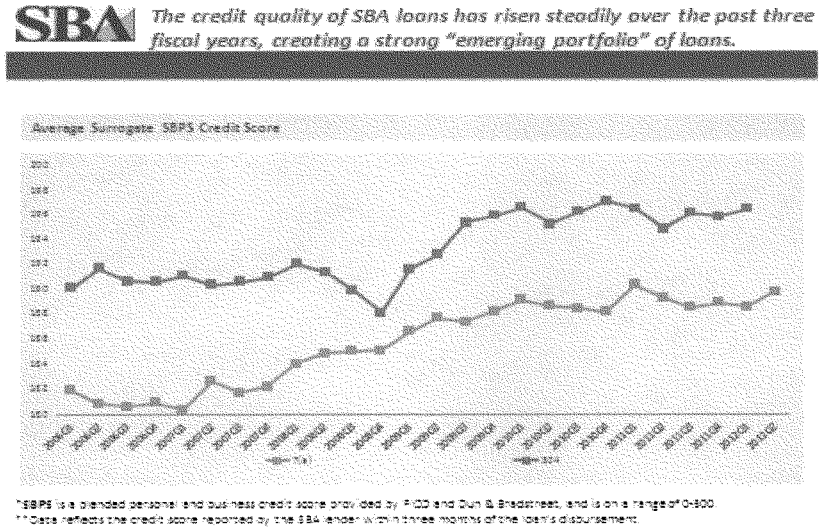
Most notably, the legacy portfolio includes loans made before the financial crisis and the real estate bubble, giving them higher risk characteristics. Essentially, the higher default rates in the 7(a) and 504 programs over the past few years were largely generated by the 2005, 2006, 2007, and 2008 cohorts. Therefore, the legacy portfolio will require greater attention in terms of servicing.

To minimize the impact on taxpayers and reduce costs, we have taken several steps to improve the liquidation and recovery process to ensure that we recoup all or at least a significant portion of the amount owed on loans in the legacy portfolio. For instance, we recently improved the way that 7(a) lenders and CDCs report their non-performing loans. This will assist us in identifying loans that are recoverable by lenders and SBA. We have also been working with the Department of Treasury to refer responsible parties for "cross servicing," which allows us access to Treasury collection tools like wage garnishment and administrative offset programs under the Debt Collection Improvement Act of 1996.

The graph set forth on the following page illustrates the current status of the default rates in the SBA 7(a) and 504 portfolios. It shows delinquency and purchase rates (defaults) are declining for the portfolio after peaking in July of 2010. This decline is due in large part to the strength of the underwriting for our emerging portfolio.




The characteristics of our emerging portfolio are strong, with an improving credit quality, as shown in the graph below.



As we worked to increase access to capital to more communities over the past few years, we have added many new lenders to the program. Consequently, we need to evaluate and closely monitor the portfolio of these lenders, who are new to SBA programs, to ensure they comply with applicable rules and reporting requirements.

**The 3-Pronged Approach**

These areas of focus described in my testimony comport with our Agency-wide approach to preventing fraud, waste, and abuse—what we call our "3-pronged" approach to risk. SBA has enhanced lender oversight by (1) providing greater focus on preventing fraud or abuse before it happens, (2) continual monitoring of loans in the SBA portfolio, and (3) strengthening our enforcement function by punishing bad actors, whether they are lenders, loan agents or borrowers.

As you may know, we successfully used this model to create a more efficient and robust contracting oversight program at the SBA. Our efforts in implementing the 3-pronged approach resulted in unprecedented actions taken against big businesses that were masquerading as small ones to land government contracts reserved for small firms.[2]

SBA has made significant progress in all three areas of our 3-pronged approach. We are now using the best practices developed through reforms in our government contracting program to bolster oversight of our loan portfolio. In addition to the improvements described earlier in my testimony, there is progress in other areas that tracks the 3-pronged approach.

Like the government contracting changes, our lender oversight improvements begin with enhanced up-front screening for SBA loans and lenders. On the individual loan side, this means making better use of the SBPS—or Small Business Predictive Score—information transmitted on each SBA loan. And on the SBA lender side, we are analyzing the lender risk rating model elements to bolster the credibility and confidence in determining qualification requirements for Small Business Lending Company (SBLC) licensing and CDC authority. At the same time we are making progress in terms of efficiency. For example, we have moved the RBR turnaround time from six months to 30 days, and we have intensified corrective action monitoring to within 60 days.

In the monitoring category—the second prong—our capabilities have improved real time portfolio monitoring to identify "red flag" loans and lenders. Once identified, these red flags are followed by more in-depth "desk reviews" of SBA loan portfolios with high-risk characteristics. Where necessary, these desk reviews will trigger comprehensive on-site reviews for lenders that engage in excessive risk taking.

And finally, as I mentioned previously, we intensified the actions taken against lenders that exhibited unacceptable risk behaviors or did not comply with SBA rules and requirements. For these higher risk lenders, the LSETF is overseeing enhanced supervision or enforcement actions as appropriate. Finally, SBA has stepped up its efforts to root out loan officers, agents, brokers,

[2] The SBA has taken 71 contracting enforcement actions since 2009. In FY 2012, SBA has supported an additional 24 contracting enforcement actions taken by other governmental agencies.

and packagers who fail to comply with our lending standards and processes or defraud the government.

Using the 3-pronged approach, we believe we now have the tools in place to sustain the improvements we have seen in the credit quality of more recent loans, to effectively manage our legacy portfolio, and to provide robust and timely enhanced supervision or enforcement of SBA lending policies in the coming years. The progress has been significant, and we look forward to building on it as we move forward.

**SBIC Oversight Framework**

I would also like to take the opportunity to discuss the oversight activities of another SBA program—the Small Business Investment Company (SBIC) program, which is housed within our Office of Investment. The office has taken three key actions to improve its SBIC oversight operations: (1) performed quantitative analysis; (2) improved data collection for SBICs; and (3) expanded the office's oversight tools. These steps have ensured strong oversight while helping to increase the number of small business investments made through our SBIC program.

In conducting quantitative analysis of the SBIC program, we hired a third party to examine the performance of our SBICs and the key characteristics that contributed to their performance. The goal was to identify those characteristics that might signal increased risks to the SBIC portfolio and improve how SBA mitigates against such risks. For instance, the analysis showed that funds with lower levels of private capital (e.g., $5 to $10 million), generally experienced higher loss rates. As a result of this finding, we increased scrutiny of those SBIC funds with $10 million or less in private capital.

Our Office of Investment also took a close look at SBA's financial reporting requirements for SBICs. As a result, we expanded the requirements to include improved portfolio company financial information and overall investment performance. This improved data collection reflects best practices suggested by the Private Equity Industry Guidelines Group and will allow SBA to more quickly and effectively identify potential problems.

The final action we took in strengthening our SBIC oversight infrastructure was to expand the risk management tools available to our analysts. For example, the Office of Investment is expanding its Web-based reporting capabilities, which will improve the quality of the data our analysts use to evaluate existing and prospective SBIC funds.

As you can see, over the past three years we have increased oversight intensity in our loan programs and in the SBIC program. Our goal continues to be to get needed capital into the hands of deserving small businesses and entrepreneurs, while being effective stewards of taxpayer dollars.

We view lender oversight as an area for ongoing improvement and are committed to sustaining and building on our recent progress. In doing so, we will continue to seek out industry best practices and feedback from members of this Committee and our small business stakeholders. We look forward to an ongoing dialogue and welcome the opportunity to work closely with you as we further strengthen and improve our lending programs.

Thank you once again for the opportunity to testify before you on this important topic, and I am happy to take your questions.

SAM GRAVES, MISSOURI
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

# Congress of the United States
## U.S. House of Representatives
## Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

June 22, 2012

The Honorable Karen G. Mills
Administrator
United States Small Business Administration
409 Third Street, S.W., Suite 7000
Washington, DC 20416

Dear Administrator Mills:

Attached, please find follow-up question stemming from your appearance before the Committee on June 6, 2012 for the hearing titled, *SBA's Management of its Capital Access Programs*. Your responses will be made part of the official record for the hearing.

Please submit your responses to the Committee by July 13, 2012. Should you or your staff have any questions concerning this request, please contact Barry Pineles, the Chief Counsel, or Andy Guggenheim, Counsel for the Committee at (202)225-5821.

Sincerely,

Sam Graves
Chairman
Committee on Small Business

Attachment

**Committee on Small Business**
**"SBA's Management of Its Capital Access Programs"**
**June 6, 2012**
**Questions for the Record**

1. Does the SBA need any clarification of authority in the Small Business Act or Small Business Investment Act of 1958 in order to remove personnel from a lender's operations? To the extent that the SBA needs such authority, please explain how that authority would work in conjunction with the oversight provided by institutions subject to regulation by an agency that is a member of the Federal Financial Institutions Examination Council.

2. The SBA has a capital access portfolio in excess of $90 billion and has no comprehensive risk management plan. Why has it taken the agency this long to establish such a plan?

3. Lenders have asked for greater transparency in decision making. How does the SBA plan on providing greater transparency when it regulates lenders through standard operating procedures that the SBA itself need not follow since those procedures are not codified in the Code of Federal Regulations?

4. What actions will the SBA take against lenders after conducting the new risk-based reviews?
    a. Will the SBA publish its enforcement policies based on these new risk-based reviews so that lenders will understand the potential consequences of maintaining risky loan portfolios?
    b. If the SBA plans to publish these enforcement policies, will they be published in the Federal Register for codification in the Code of Federal Regulation or will the SBA utilize standard operating procedures for establishing the consequences of a poorly-maintained loan portfolio?
    c. If the SBA plans on publishing them as standard operating procedures, why would the agency take that route?

5. In your testimony, you cite that 50 loan officers, brokers, packagers, and applicants were suspended or debarred in FY 2009.
    a. First, how many were debarred and what is the breakdown between applicants, brokers, etc.?
    b. Second, what about more recent statistics on such suspensions or debarments, that is for fiscal years subsequent to FY 2009?
    c. Has the SBA ever suspended or debarred any personnel from a lender (other than a small business lending company as that term is defined in § 23 of the Small Business Act) operating pursuant to § 7(a) of the Small Business Act or a certified development company operating pursuant to Title V of the Small Business Investment Act of 1958?

6. Other agencies publish their delegation of authorities in the Code of Federal Regulations or in the equivalent of standard operating procedures. Why does the SBA choose to only alert the public to the delegations through publication in the Federal Register?

7. You stated that the SBA did not renew preferred lender status for 347 lenders during the last three fiscal years. Of those, how many were not renewed because they did an insufficient volume of lending to maintain their delegated authority status?

8. According to your testimony, the SBA has revoked the accredited lender status of an average of two certified development companies per year, which is less than one percent of the total number of certified development companies in the United States. Are you suggesting that all the other certified development companies are operating in accordance with SBA's regulations and standard operating procedures? If so, what percentage of certified development companies have risk ratings that put them in the highest risk category?

9. Has the SBA ever revoked the authority of a certified development company (be it certified, accredited or premier) to operate as a certified development company?

10. SBA makes most of its changes to the operation of its capital access programs through modifications to standard operating procedures for which notice and comment are not required. Would not the informal process of obtaining comment, as spelled out in the Administrative Procedure Act and the § 101.108 of Title 13, Code of Federal Regulations, ensure input from affected entities and eliminate potential implementation problems before new procedures were put in place?

11. The SBA regulations delinate procedures for taking enforcement action against lenders operating in the 7(a) loan program or certified development companies operating pursuant to Title V of the Small Business Investment Act of 1958. However, those regulations allow the SBA to continually delay a final decision. Do you think that is fair to either the lenders or the taxpayers that may be guaranteeing loans from participating lenders who are in violation of statute or regulations or a combination thereof?

12. Please provide the Committee with the appropriate citations, in statute, regulation, or standard operating procedure for the structure and procedures by which the Loan Oversight Committee functions?
    a. If the SBA does not have established procedures for how the Loan Oversight Committee operates, how does the SBA ensure that the decisions of the Loan Oversight Committee do not treat similarly situated entities differently?
    b. Would not open and transparent government suggest that the SBA publish the procedures by which the Loan Oversight Committee operates?
    c. If the procedures and structure of the Loan Oversight Committee is not published, what is the rationale for not providing that information to the public and the regulated community especially given the Supreme Court's recent decision in *FCC v. Fox Television Stations, Inc.* where the court noted that agencies must inform the regulated community of standards that apply?

13. In what documents adopted by the SBA and recognized as a formal agency pronouncement under the standards set forth in *United States v. Mead Corp.*, 533 U.S. 218 (2001) would one be able to find the application procedures to obtain a license under Title III of the Small Business Investment Act of 1958?

14. The SBA utilizes a committee to vote on whether an application for a SBIC license should be granted. Please identify where that procedure is specified in the regulations or SBA standard operating procedures?
    a. If the existence of that committee has not been published in the Code of Federal Regulation or the SBA's standard operating procedures, how does an applicant know what standards it needs to meet in submitting an application?
    b. If the standards by which the committee votes are not published anywhere and an applicant wishes to challenge the SBA's action in court, what record will the that votes present to a reviewing court?

15. Both United States Government Accountability Office and the SBA's Inspector General have stated that that the Office of Credit Risk Management does not have the necessary organizational independence to do its job effectively. Both recommended separating that office from the Office of Capital Access. Why has this recommendation not been implemented?

16. When will the performance benchmarks for lenders be available?
    a. Will those be published in the Federal Register for comment? If not, why not?
    b. Will those benchmarks be incorporated into agency regulations, standard operating procedures or some other agency policy document? If not, why not?

17. If loans made from 2005 to 2008 are performing worse as a result of the financial crisis, what safeguards can be put in place to improve underwriting standards moving forward?

18. In the Committee's Views and Estimates letter for Fiscal Year 2013, the Committee endorsed establishing separate subsidy rates for pilot programs in order to determine their true cost to the taxpayers. Does SBA support a separate subsidy rate calculation for the 7(a) pilot programs? If not, why not?

19. Congressman West was approached by several CDCs requesting that he support an extension of both the 504 Refinance Program and the First Mortgage Lien Pool provisions, in part because the SBA took more than a year to promulgate regulations to implement the programs. Why did it take more than a year to implement the program?
    a. Given the lengthy implementation period, do you believe that the programs should be reauthorized so that they could operate for the time period contemplated by Congress when it enacted the programs?
    b. What would be the impact of implementation on the subsidy rate for the lending program established pursuant to Title V of the Small Business Investment Act of 1958?

20. Congressman Landry raised certain concerns over the redesignation of parishes in his district in a letter to you on October 21, 2011. At the hearing, he noted concerns about the methodology used and while he disagrees with that methodology appreciates the SBA's willingness to work with him on this matter. Given that introduction, what steps did the SBA take or will take to ensure the unequivocal validity of the American Community Survey data in performing the redesignation of HUBZone areas?
    a. Were possible errors, incompleteness, or "holes" in the data taken into account when designating HUBZones?
    b. Does the 2010 American Community Survey data reflect the long-term economic duress caused by the 2010 Deepwater Horizon oil spill and similar disruptions to the local economy of coastal Louisiana?

21. In your testimony, both on June 6, 2012 and prior appearances before the Committee, you mention that one of the pillars of the SBA is to make credit available to small businesses. Yet, small businesses in Congresswoman Herrera-Beutler's district continues to face difficulty in obtaining credit, especially if they are using real estate as collateral. For example, an electrician in Olympia, WA has been in business since 1980 and a difficult economy forced him to use credit to make ends meet. Despite a business turnaround and being current on all bills and taxes, he was turned down for a SBA loan.
    a. Do loan officers have the flexibility to make an independent judgment on the credit quality of a small business, or is a loan approval solely dependent on the borrower's credit score?
    b. If it solely depends on credit score, how does that ensure that the SBA is accomplishing its mission to provide credit to small businesses?

22. Another small business owner in Congresswoman Herrera-Beutler's district explained that despite a longstanding relationship with his local bank and solid credit history, the bank did not renew his line of credit or provide him with any other options to obtain a line of credit. In your opinion, is overall small business lending returned to normalcy where businesses with solid track records are able to obtain lines of credit needed to operate?

23. During the hearing Congresswoman Herrera-Beutler inquired about a business who applied for a loan with a SBA-authorized guaranteed lender. The lender first gave a line of credit while it supposedly worked to process the application (including requesting and receiving supplementary information from the small business owner) and then converted that line of credit into a high-interest term loan. Do you believe that this is appropriate behavior by a bank?
    a. How much discretion does a lender have when it comes to deciding whether to make a loan?
    b. What regulations or standard operating procedures exist to prevent a lender from falsely claiming that it is processing an application to the SBA and then not submit such an application?
    c. What enforcement actions are available for the SBA to take against lenders who conduct this type of "bait and switch"?

24. During the hearing, Congressman Mulvaney asked whether SBA is seeing any trends in reasons for taking enforcement action against lending partners and other financial assistance program participants, users or loan packagers. Please detail the top reasons for taking enforcement action, any trends with respect to enforcement and what SBA is doing to address this behavior.

**The U.S. Small Business Administration**
**responses to**
**House Committee on Small Business'**
**Questions for the Congressional Record**
**for the hearing entitled:**
**"SBA's Management of Its Capital Access Programs"**
**June 6, 2012**

**1a. Does the SBA need any clarification of authority in the Small Business Act or Small Business Investment Act of 1958 in order to remove personnel from a lender's operations?**

SBA has express statutory authority to remove management officials from small business investment companies (SBICs) and SBA Supervised Lenders. We also have authority to take government-wide debarment actions against both entities and individuals in appropriate cases. Additional authority to remove personnel from a lender's operations with respect to other participant lenders would be useful to SBA's lender supervision and enforcement programs.

**1b. To the extent that the SBA needs such authority, please explain how that authority would work in conjunction with the oversight provided by institutions subject to regulation by an agency that is a member of the Federal Financial Examinations Council.**

SBA would work with Federal Financial Institution Examination Council members to remove, if appropriate, an individual from an SBA Lender's SBA operations.

**2. The SBA has a capital access portfolio in excess of $90 billion and has no comprehensive risk management plan. Why has it taken the agency this long to establish such a plan?**

SBA does have a comprehensive risk management plan that includes lender monitoring, supervision, and enforcement, as well as overall SBA portfolio monitoring. SBA performs extensive lender monitoring that includes, but is not limited to, lender reporting, portfolio monitoring through the Loan and Lender Monitoring System (LLMS), and risk-based reviews. On an annual basis, the Office of Credit Risk Management (OCRM) identifies a list of lenders for on-site and off-site reviews based on lenders who present the highest risk to the SBA portfolio as well as those lenders requesting delegated authority. On an ongoing basis as the need occurs, OCRM identifies those lenders that require increased supervision. Increased supervision includes, but is not limited to, corrective actions required, secondary market sales evaluations, and shortened renewal of delegated authorities. SBA's overall risk management plan is incorporated in its standard operating procedures for Lender Supervision and Enforcement (SOP 50 53). Under the direction of Brent Ciurlino, the new Director of OCRM, SBA is reassessing its organizational and operating risk management strategies and reviewing all risk elements. OCRM is currently preparing a separate Annual Risk Management Operating/Audit Plan for FY 2013. This plan will further update the key goals, objectives, and components in our overall lender and portfolio risk management programs.

**3. Lenders have asked for greater transparency in decision making. How does the SBA plan on providing greater transparency when it regulates lenders through standard operating procedures that the SBA itself need not follow since those procedures are not codified in the Code of Federal Regulations?**

SBA regulates lenders in accordance with its statutes (e.g., Small Business Act and Small Business Investment Act of 1958) and regulations (e.g., 13 C.F.R. Parts 103, 107, 108, 109, 112, 113, 117, 120, 136, 140 and 142). The Agency's SOPs provide lenders and other parties greater transparency into Agency procedures and guidance. As stated in SBA's SOP 00 23 6, Directives Management Program, Ch. 4, "Standard Operating Procedures (SOPs) are permanent directives which set forth policies and procedures relating to Agency programs or activities. The Agency uses SOPs to disseminate the official permanent policies and procedures. Agency personnel use SOPs to determine what their functions and responsibilities are and how to perform their jobs. SOPs also clarify and elaborate on laws and regulations. In the event of a conflict between SOP and laws or regulations, laws and regulations control." SBA also engages in robust outreach to lenders and other program participants year-round and incorporates the feedback into the SOP revision process. SBA posts SOPs on the public SBA website, http://www.sba.gov.

**4. What actions will the SBA take against lenders after conducting the new risk-based reviews?**

OCRM's new risk-based review process will be an integrated assessment of lenders through off-site and on-site activities, resulting in a Composite Rating that will further inform subsequent actions and level of supervision. These subsequent actions may include requirements for corrective action plans including milestones and periodic follow-up reporting, modification of delegated lender authorities, modification of secondary loan sales approvals, and/or modification of other lender privileges. Enhanced actions may include referral to OCRM's supervision/enforcement docket for consideration of more serious actions, such as restricting a lender's authority to do business with SBA or immediate suspension of privileges if conditions are egregious and warrant immediate action.

**4a. Will the SBA publish its enforcement policies based on these new risk-based reviews so that lenders will understand the potential consequences of maintaining risky loan portfolios?**

SBA will update its Lender Supervision and Enforcement SOP (SOP 50 53) to reflect any changes in the scope of lender monitoring and increased supervision policies and practices that may result from the new risk-based assessments and reviews. SBA also anticipates periodically revising and updating its On-Site Lender Reviews/Examinations SOP (SOP 51 00) as SBA implements and further develops its comprehensive risk management plan. These SOPs are available to the public on SBA's website at www.sba.gov.

**4b. If the SBA plans to publish these enforcement policies, will they be published in the Federal Register for codification in the Code of Federal Regulation or will the SBA utilize standard operating procedures for establishing the consequences of a poorly-maintained loan portfolio?**

SBA has enforcement regulations that were published in the Federal Register and are codified at 13 CFR 120.1400 through 120.1600, which will be updated as necessary. SBA also publishes on the SBA website its internal on-site review/examination procedures and general guidance in SBA SOP 51 00. In addition, SBA publishes on the SBA website its Lender Supervision and Enforcement SOP (SOP 50 53) that contains internal enforcement procedures and general guidance. Each of the SOPs will be updated as necessary.

**4c. If the SBA plans on publishing them as standard operating procedures, why would the agency take that route?**

SBA's enforcement regulations were published in the Federal Register. SOP 51 00 governing On-Site Lender Reviews/Examinations and SOP 50 53 governing Lender Supervision and Enforcement, however, were published as standard operating procedures because they contain internal agency procedures and general guidance.

**5. In your testimony, you cite that 50 loan offers, brokers, packagers, and applicants were suspended or debarred in FY 2009.**

Respectfully, Administrator Mills' written testimony actually reads "since FY 2009, we have suspended or debarred over 50 loan officers, loan brokers, packagers, and applicants in the 7(a) program." While stated slightly differently, the Administrator's oral testimony is consistent with her written testimony.

**5a. First, how many were debarred and what is the breakdown between applicants, brokers, etc.?**

The most current data shows that 66 individuals and businesses have been suspended or debarred since FY 2009, consisting of 59 applicants, 6 broker/packagers and 1 loan officer.

**5b. Second, what about more recent statistics on such suspensions or debarments, that is for fiscal years subsequent to FY 2009?**

The answer to 5(a) is responsive to 5(b) as well.

**5c. Has the SBA ever suspended or debarred any personnel from a lender (other than a small business lending company as that term is defined in §23 of the Small Business Act) operating pursuant to §7(a) of the Small Business Act or a certified development company operating pursuant to Title V of the Small Business Investment Act of 1958?**

Yes. In FY2011, a loan officer was suspended, and later debarred, pursuant to 2 C.F.R. § 180.800.

**6. Other agencies publish their delegation of authorities in the Code of Federal Regulations or in the equivalent of standard operating procedures. Why does the SBA choose to only alert the public to the delegations through publication in the Federal Register?**

There is no requirement that delegations of authorities be published in the Code of Federal Regulations. SBA complies with the Administrative Procedure Act (APA) by publishing its delegations of authorities in the Federal Register. A quick review of the Federal Register indicates that many other Agencies follow this practice.

**7. You stated that the SBA did not renew preferred lender status for 347 lenders during the last three fiscal years. Of those, how many were not renewed because they did an insufficient volume of lending to maintain their delegated authority status?**

In FY 2010 and 2011, SBA did not renew approximately 25 lenders' PLP status due to concerns with insufficient volume relating to the lenders' ability to effectively process and close SBA loans. SBA began tracking this information in FY 2010.

Please note that although we originally reported that 347 authorities were denied in FYs 2009 through 2011, we realize upon closer review that we should have indicated "approximately 340" such non-renewals instead.

**8. According to your testimony, the SBA has revoked the accredited lender status of an average of two certified development companies per year, which is less than one percent of the total number of certified development companies in the United States.**

**8a. Are you suggesting that all other certified development companies are operating in accordance with SBA's regulations and standard operating procedures?**

SBA routinely conducts program oversight which includes reviews of CDC compliance with Agency regulations. These reviews generally take the form of risk-based reviews, delegated authority reviews (ALP/PCLP) and off-site reviews. Following a risk-based review, SBA issues a report containing findings, conclusions, and a request for corrective actions (e.g., relating to areas of non-compliance identified during the review), as applicable. SBA reviews and approves the CDC's proposed corrective actions and follows-up at the next review of each CDC that had previous findings. The process to receive and maintain ALP or PCLP delegated status includes a review of a CDC's compliance with Agency regulations. This review also includes the review of any findings and the proposed corrective actions.

As a result of these reviews, we are currently evaluating approximately 27 CDCs that may not meet regulatory requirements with respect to governance, good standing with their respective states, loan origination, reporting, or portfolio servicing. In these situations, SBA works with the CDCs to correct the deficiency and may accept a voluntary de-certification or take other supervisory or enforcement action, as appropriate.

**8b. If so, what percentage of certified development companies have risk ratings that put them in the highest risk category?**

Of the approximately 272 CDCs currently participating in SBA's 504 Loan Program, 7 CDCs, or 2.6 percent of the CDCs and 4.6 percent of the dollars, are in the highest risk category.

**9. Has the SBA ever revoked authority of a certified development company (be it certified, accredited, or premier) to operate as a certified development company?**

Administrator Mills testified that SBA declined to renew the delegated lender authority of 7 CDCs in the Accredited Lenders Program over the past 3 years because these companies did not meet SBA loan program requirements. Generally, if a CDC is unable or unwilling to correct a program deficiency, SBA may allow the CDC to voluntarily withdraw from the program, if appropriate. To date, 5 CDCs have done so, obviating the need for SBA to take an enforcement action to revoke their authority. We anticipate more will voluntarily withdraw as SBA continues to step-up lender oversight, supervision, and enforcement. We note that SBA is reviewing other CDCs for possible enforcement, which may include but is not limited to, revocation of authority to participate in the program.

**10. SBA makes most of its changes to the operation of its capital access programs through modifications to standard operating procedures for which notice and comment are not required.**

**10a. Would not the informal process of obtaining comment as spelled out in the Administrative Procedure Act and the §101.108 of Title 13, Code of Federal Regulations, ensure input from affected entities and eliminate potential implementation problems before new procedures were put in place?**

SOPs are not subject to notice and comment rulemaking under the APA. As stated in the response to question number 3 above, however, SBA engages in robust outreach to lenders and other program participants year-round and incorporates the feedback into the SOP revision process. This outreach effort is continued after each SOP update is released to further ensure feedback from our lenders and other program participants.

**11. The SBA regulations delineate procedures for taking enforcement action against lenders operating in the 7(a) loan program or certified development companies operating pursuant to Title V of the Small Business Investment Act of 1958. However, those regulations allow the SBA to continually delay a final decision.**

**11a. Do you think that it is fair to either the lenders or the taxpayers that may be guaranteeing loans from participating lenders who are in violation of statute or regulations or a combination thereof?**

The process of taking an enforcement action, e.g., revoking the authority of lenders, CDCs and other participants, can be long and complicated. Before taking an enforcement action, SBA affords lenders appropriate due process that generally begins with providing the lenders an opportunity to demonstrate or achieve compliance or to self-correct. This is generally done while the lender is under increased supervision by SBA. If corrective action efforts are unsuccessful, SBA may take progressive action to increase supervision and limit risk (e.g., provide a shortened renewal for delegated authority) or commence enforcement actions (e.g., to remove a program participant).

**12. Please provide the Committee with the appropriate citations, in statute, regulation, or standard operating procedure for the structure and procedures by which the Loan Oversight Committee functions?**

The Lender Oversight Committee delegations of authority are published in SBA Delegations of Authority 12-G, Paragraph I(B), 70 FR 21262 (April 25, 2005). The delegations are generally restated in SOP 50 53 on Supervision and Enforcement, Chapter 4, Paragraph 5(a)(v).

**12a. If the SBA does not have established procedures for how the Loan Oversight Committee operates, how does the SBA ensure that the decisions of the Loan Oversight Committee do not treat similarly situated entities differently?**

SBA does have established procedures for how the Lender Oversight Committee operates, as set forth in the Delegations of Authority and SOP 50 53. These procedures contemplate, among other things, that the Director, Office of Credit Risk Management, will make recommendations to the Lender Oversight Committee for enforcement actions and that the Office of General Counsel will provide a legal review of all actions before they are taken.

**12b. Would not open and transparent government suggest that the SBA publish the procedures by which the Loan Oversight Committee operates?**

SBA has published enforcement procedures in both the Code of Federal Regulations and SBA's SOP 50 53.

**12c. If the procedures and structure of the Loan Oversight Committee is not published, what is the rationale for not providing that information to the public and the regulated community especially given the Supreme Court's recent decision in FCC vs. Fox Television Stations, Inc. where the court noted that agencies must inform the regulated community of standards that apply?**

See answer to 12b above.

**13. In what documents adopted by the SBA and recognized as a formal agency pronouncement under the standards set forth in United States vs. Mead Corp., 533 U.S. 218 (2001) would one be able to find the application procedures to obtain a license under Title III of the Small Business Investment Act of 1958?**

SBA Standard Operating Procedure 10-04 addresses the process for obtaining a Small Business Investment Company (SBIC) license. This SOP is being updated to reflect current processes. Currently, SBA Forms 2181, 2182 and 2183 (SBIC Management Assessment Questionnaire and License Application) outline the procedures to apply for an SBIC license. (OMB Approval No. 3245-0062) In particular, SBA Form 2181 explains that applying for an SBIC license is a two-part process that begins with completion of the *Management Assessment Questionnaire* (MAQ), which SBA reviews as the first step in its process of determining whether a management team has the qualifications necessary to manage an SBIC. SBA Form 2181 continues by providing that, if SBA believes that there is sufficient evidence that a management team may have the qualifications to manage an SBIC, the entire team is invited to participate in an interview with SBA's Investment Committee. After the interview, the Investment Committee considers whether the management team appears to have the necessary experience and skills to manage an SBIC. If affirmative, the management team will be invited to submit a formal license application. The SBIC Management Assessment Questionnaire and License Application contain instructions for completion of the forms and submission of the information required to be submitted by a license applicant. Section 301(c) of the Small Business Investment Act of 1958, as amended (Act), specifies the factors that must be considered by SBA in determining whether to issue an SBIC license under Title III of the Act.

**14. The SBA utilizes a committee to vote on whether an application for a SBIC license should be granted. Please identify where that procedure is specified in the regulations or SBA standard operating procedures?**

> **a. If the existence of that committee has not been published in the Code of Federal Regulations or the SBA's standard operating procedures, how does an applicant know what standards it needs to meet in submitting an application?**
>
> **b. If the standards by which the committee votes are not published anywhere and an applicant wishes to challenge the SBA's action in court, what record will the that [sic] votes present to a reviewing court?**

Pursuant to Section 301(c)(2)(B) of the Small Business Investment Act of 1958, as amended (Act), the Administrator approves all licensing applications and issues SBIC licenses, taking into consideration the factors required by Section 301(c)(3) of the Act and Part 107 of Title 13 of the Code of Federal Regulations. The Act and the regulations are available to the public on SBA's website in addition to other websites available to the public and in public libraries. The Administrator has delegated to the Agency Licensing Committee, under a Delegation of Authority published in the Federal Register, the authority to take any and all actions necessary to review applications for licensing under Section 301 of the Act and to recommend to the Administrator which such applications should be approved. In accordance with this Delegation of Authority, the Agency Licensing Committee reviews SBIC license applications and makes recommendations to the Administrator, who makes the final determination. The most recent such Delegation of Authority is published at 76 FR 10420 (February 24, 2011).

**15. Both United States Government Accountability Office and the SBA's Inspector General stated that the Office of Credit Risk Management does not have the necessary organizational independence to do its job effectively. Both recommended separating that office from the Office of Capital Access. Why has this recommendation not been implemented?**

SBA created the Office of Credit Risk Management (OCRM) as a separate office, independent of SBA's Office of Financial Assistance, in recognition of the need for a distinct group whose responsibilities include (i) directing and coordinating SBA's lender oversight activities; (ii) recommending enforcement actions to the Lender Oversight Committee and taking such actions; and (iii) providing policy, program, and portfolio analysis for SBA's loan programs and portfolios. SBA continues to believe, however, that housing OCRM under the Office of Capital Access (OCA) is critical to OCRM's successful functioning and, ultimately, to the success of SBA's loan programs. To run an effective program there has to be open communication and critical information sharing between key offices that can only be achieved if they operate in tandem. Co-location of OCRM within OCA, at this time, offers a number of other opportunities for information sharing and coordination toward systematically improving the loan programs, lender performance, governance and field centered activity.

SBA also established the Lender Oversight Committee to assist OCRM in its oversight and monitoring role. The Committee's role provides additional support for OCRM's independence. The Committee is chaired by the Chief Operating Officer and includes representation from outside the Office of Capital Access, including the Chief Financial Officer, and representatives from the Office of General Counsel and the Office of Field Operations.

With the downturn in the economy, SBA has taken a number of other steps to strengthen our developing oversight, supervision, and enforcement program and its independence. SBA has recently brought in a new director of OCRM with prior FDIC experience. The director of OCRM is a senior executive service level position whose second line supervisor is the Chief of Staff. The new director is currently assessing all aspects of the risk-based review program and lender oversight in accordance with best practices at other agencies. The new director is also establishing a separate Supervision and Enforcement Unit within OCRM that will be using a docket case management system. The Supervision and Enforcement Unit will report on the lenders in the docket to SBA's independent Lender Oversight Committee. This Unit, together with certain lawyers from the Office of General Counsel, constitutes the Agency's new Lending Supervision and Enforcement Task Force. Through all these efforts, as well as an intensified involvement of the Lender Oversight Committee, SBA believes that a level of effective independence is being established.

**16. When will the performance benchmarks for lenders be available?**

OCRM is working with Dun & Bradstreet on validation and redevelopment of its risk rating system, which is anticipated to be completed in Fall 2012. OCRM is also redeveloping its risk-based reviews process that will include establishment of benchmark guidelines from this risk rating system. These benchmarks will be used to inform SBA financial analysts in conducting more focused review activities. These benchmarks are anticipated to be ready for implementation also in Fall 2012, and will be made available to SBA's lending partners.

**16a. Will those be published in the Federal Register for comment? If not, why not?**

The benchmarks are still under development and a determination will be made as to the appropriate form of publication.

**16b. Will those benchmarks be incorporated into agency regulations, standard operating procedures or some other agency policy document? If not, why not?**

See the response to #16a.

**17. If loans made from 2005 to 2008 are performing worse as a result of the financial crisis, what safeguards can be put in place to improve underwriting standards moving forward?**

SBA took a major step in improving underwriting of lower-dollar loans (defined as $350,000 or less) in FY 2012. This improvement, called Small Loan Advantage (SLA) 2.0, allows lenders to pre-validate credit worthiness by accessing a credit score of the business from SBA before a loan approval is given and an SBA guaranty is applied. A full underwriting of the loan is still required to be performed by the lender. Since the release of SLA 2.0, SBA approved approximately $10 million in small dollar loans through SLA 2.0, reflecting an increase of 2.5 times compared to the prior average monthly amount of small dollar loans approved. The credit score component, combined with the required underwriting, is expected to reduce the number of high risk loans being approved. SBA has also strengthened and expanded its review process for improper payments to include underwriting standards for both delegated and nondelegated guaranteed loans.

**18. In the Committee's view and Estimates letter for Fiscal Year 2013, the Committee endorsed establishing separate subsidy rates for pilot programs in order to determine their true cost to the taxpayers. Does SBA support a separate subsidy rate calculation for the 7(a) pilot programs? If not, why not?**

The 7(a) general business loans subsidy costs are a weighted average rate of all expected loan guarantees, reflecting the portfolio nature of the program. All actual performance and updated expectations of future performance are reflected in re-estimates, and new subsidy estimates reflect observed performance of similar outstanding loans. Even though SBA's current 7(a) pilot programs are managed within the overall 7(a) portfolio, the SBA has the ability to monitor performance separately, taking action when appropriate to mitigate risk and costs, as well respond to all stakeholder inquiries.

**19. Congressman West was approached by several CDCs requesting that he support an extension of both the 504 Refinance program and the First Mortgage Lien Pool provisions, in part because the SBA took more than a year to promulgate regulations to implement the programs.**

**19a. Why did it take more than a year to implement the program?**

The 504 Refinance Program and the First Mortgage Lien Pool Program are two distinct programs that were authorized at different times and were separately implemented. The First Mortgage Lien Pool Program was established by statute in Section 503 of the American Recovery and Reinvestment Act of 2009 on February 17, 2009. The 504 Refinance Program was authorized under the Small Business Jobs Act enacted on September 27, 2010. SBA addresses each program separately below.

504 Refinance Program:
It did not take the agency one year to implement the 504 Refinance Program. The Jobs Act was enacted on September 27, 2010 and the agency issued implementing regulations less than 5 months later on February 17, 2011 (76 FR 9213), which were effective immediately. SBA began accepting applications under the program on February 28, 2011. During March 2011, the agency approved 5 loans for an aggregate dollar value of $2,074,000. Based on comments received and the response to the interim final rule, the agency made changes to the program and issued a final rule on October 12, 2011 (76 FR 63151). With these changes, SBA continued to see increased utilization of the program and from January through June 2012, averaged 171 loan approvals per month. As of July 13, 2012, the agency has approved a total of1,681 loans in an aggregate amount of $1,517,570,000.

First Mortgage Lien Pool Program:
The creation of a new secondary market and a new government security is a complex undertaking. The following is a list of tasks that had to be completed before the first loan pool could be settled. In many cases, the tasks had to be completed sequentially and could not be worked on simultaneously.

1. The first step was to create the structure for the security. The statute requires a timely payment mechanism for investors. There were several factors that had to be investigated before a structure could be finalized. These included determining (i) the impact on borrowers, (ii) how lenders would interact with the process, and (iii) what investors were expecting.
2. Once a structure was created, a statement of work had to be drafted identifying each of the steps necessary from collection of borrower payments to payment to investors. This process could not begin until step one was completed. Due to the fiduciary nature of the process, the appropriate safeguards for the money while in transit had to be developed and written very specifically into contract language.
3. After the statement of work was completed, SBA had to determine if an existing contractor could handle the work or if a separate procurement had to be conducted. SBA saved several months because the activities required to operate the new securities program were similar to the requirements in the existing Central Servicing Agent contract.
4. Upon completion of the structure and contracting, SBA and the contractor could begin doing the programming necessary to make the process work. Whenever a new "system" is created, there are several steps that SBA must take to ensure that the process is handled properly. SBA diligently followed each of these steps, including the reviews necessary along the way. The programming and system work took several weeks.

5. Simultaneous with the programming and systems work, SBA began drafting the contract executed by the parties at the time of a sale. This is a very detailed document designed to make sure all parties know what is expected of them. A follow on to this project was the design and printing of the actual security that is used.
6. Finally, while the programs and document drafting were going on, SBA began marketing the new security. Investors need to have all of the details and understanding the amount and timing of all of the cash flows so that they can properly price the security. SBA conducted various types of outreach including direct outreach to certain investors and participation in conferences.

All of these steps were necessary prior to the settlement of the first loan pool. It is noted that there have been 100 pools issued as of July 6, 2012; value of all the pools is approximately $430.8 million. During June 2012, seven pools were issued for $34.6 million. May 2012 was the most active month for this program by both dollars and pools originated.

**19b. Given the lengthy implementation period, do you believe that the programs should be reauthorized so that they could operate for the time period contemplated by Congress when it enacted the programs?**

The rapid growth in the Jobs Act 504 refinance loan volume, particularly since the final rule was published on October 12, 2011, resulted in a first quarter FY 2012 total of 278 approved loans and $250,995,000 in dollar amount. By comparison, the second quarter activity increased by 64% in approved loans (456 loans) and 71% in dollar amount ($429,230,000). Similarly, the third quarter increased by 107% in approved loans (575 loans) and 108% in dollar amount ($521,860,000) over the first quarter FY 2012. This performance indicates strong market usage of this program.

As of July 13, 2012, the agency has approved a total of 1,681 loans for an aggregate amount of $1,517,570,000. We have heard strong support from our lending partners for extension of both the 504 Refinance Program and the First Mortgage Lien Pool Program.

**19c. What would be the impact of implementation on the subsidy rate for the lending program established pursuant to Title V of the Small Business Investment Act of 1958?**

The secondary market program for 504 first mortgages is modeled separately from SBA's 504 loan program and would not impact the subsidy model for 504 loans. The 504 refinance program is also separately modeled and would also have no impact on the model for 504 loans.

**20. Congressman Landry raised certain concerns over the redesignation of parishes in his district in a letter to you on October 21, 2011. At the hearing, he noted concerns about the methodology used and while he disagrees with that methodology he appreciates the SBA's willingness to work with him on this matter.**

**20a. What steps did the SBA take or will take to ensure the unequivocal validity of the American Community Survey data in performing the redesignation of HUBZone areas?**

A redesignated HUBZone is any census tract or any non-metropolitan county that ceases to be a qualified HUBZone and is therefore redesignated for three years after the date on which the census tract or non-metropolitan county ceased to be so qualified. SBA uses the following data from the American Community Survey (ACS) and the 2010 Census to determine if the Nonmetropolitan County is qualified as a HUBZone based on median household income:

- Median Household Income for Counties from the ACS available at http://www.census.gov/acs/www/
- Number of Households per County from the 2010 Census data available at http://2010.census.gov/2010census/data/

The HUBZone maps undergo various rounds of testing, first by the map contractor and then by SBA, before being validated and released to the public.

**20b. Were possible errors, incompleteness, or "holes" in the data taken into account when designating HUBZones?**

The statute and regulations define a HUBZone to mean an area located within one or more qualified census tracts, qualified non-metropolitan counties, lands within the external boundaries of an Indian reservation, redesignated areas, or base closure areas. 15 U.S.C. § 632(p)(1); 13 C.F.R. § 126.103. SBA relies on data from other Government sources listed below. SBA has a contractor that takes that data and geocodes it. The HUBZone maps are tested and validated by the contractor and SBA prior to being released to the public. Additionally, HUBZone applications specifically allow small businesses to provide a written explanation when they believe that map results are inaccurate. Then SBA evaluates the information provided and makes a subsequent determination.

Data sources:

- U.S. Housing and Urban Development: designation of Qualified Census Tracts (QCTs) and Difficult Development Areas (DDAs) located in nonmetropolitan counties.
- Census Bureau and U.S. Department of Labor – Bureau of Labor Statistics (BLS) – Local Area Unemployment Statistics Program (LAUS). Using the Census and BLS-LAUS data, SBA performs the calculations to identify Qualified Nonmetropolitan Counties (QNMCs). A QNMC is any county not located in a metropolitan area that meets any or all of the following three criteria:
  1) the county's median household income is less than 80% of the nonmetropolitan state median household income, based on the most recent data available from the Census; or
  2) the county's unemployment rate is not less than 140 percent of the average unemployment rate for the United States or for the State in which such county is located, whichever is less, based on the most recent data available
- U.S. Department of Interior – Bureau of Indian Affairs: designates the lands within the external boundaries of an Indian reservation
- U.S. Department of Defense – Office of Economic Adjustment: provides the list of military installations that were closed through a privatization process under the authority of the Defense Base Closure and Realignment Act of 1990 (part A of title XXIX of division B of Public Law 101–510; 10 U.S.C. 2687 note); Title II of the Defense Authorization Amendments and Base Closure and Realignment Act (Pub. L. 100–526; 10 U.S.C. 2687 note); 10 U.S.C. 2687; or any other provision of law authorizing or directing the Secretary of Defense or the Secretary of a military department to dispose of real property at the military installation for purposes relating to base closures of redevelopment, while retaining the authority to enter into a leaseback of all or a portion of the property for military use.

A redesignated area is any census tract or any non-metropolitan county that ceases to be a qualified HUBZone and is redesignated for three years after the date on which the census tract or non-metropolitan county ceased to be so qualified.

**20c. Does the 2010 American Community Survey data reflect the long-term economic duress caused by the 2010 Deepwater Horizon oil spill and similar disruptions to the local economy of coastal Louisiana?**

The United States Census Bureau performs the American Community Survey and is the government entity who can answer what data goes into the survey.

**21. In your testimony, both on June 6, 2012 and prior appearances before the Committee, you mention that one of the pillars of the SBA is to make credit available to small businesses. Yet, small businesses in Congresswoman Herrera-Beutler's district continues to face difficulty in obtaining credit, especially if they are using real estate as collateral. For example, an electrician in Olympia, WA has been in business since 1980 and a difficult economy forced him to use credit to make ends meet. Despite a business turnaround and being current on all bills and taxes, he was turned down for a SBA loan.**

**21a. Do loan officers have the flexibility to make an independent judgment on the credit quality of a small business, or is a loan approval solely dependent on the borrower's credit score?**

SBA does not approve loans based solely on the borrower's credit score. SBA regulations at 13 CFR 120.150 state that "the applicant . . . must be creditworthy. Loans must be so sound as to reasonably assure repayment. SBA will consider: (a) character, reputation and credit of the applicant . . ., its Associates, and guarantors; (b) experience and depth of management; (c) strength of the business; (d) past earnings, projected cash flow and future prospects; (e) ability to repay the loan with earnings from the business; (f) sufficient invested equity to operate on a sound financial basis; (g) potential for long-term success; (h) nature and value of collateral (although inadequate collateral will not be the sole reason for denial of a loan request); and (i) the effect any affiliates (as defined in part 121 of this chapter) may have on the ultimate repayment ability of the applicant." Loan officers do have the flexibility to make independent decisions based upon the credit quality of the small business applicant and the individual loan request. In addition, SBA has been encouraging its lending partners, through outreach and lender trainings, to consider transactions involving refinancing and restructures to assist businesses that have been impacted during the recession but who have now clearly demonstrated solid turnarounds.

**21b. If it solely depends on credit score, how does that ensure that the SBA is accomplishing its mission to provide credit to small businesses?**

As indicated above, a loan's approval does not solely depend on credit score.

**22. Another small business owner in Congresswoman Herrera-Beutler's district explained that despite a longstanding relationship with his local bank and solid credit history, the bank did not renew his line of credit or provide him with any other options to obtain a line of credit.**

**22a. In your opinion, is overall small business lending returned to normalcy where businesses with solid track records are able to obtain lines of credit needed to operate?**

According to the most recent Federal Reserve quarterly survey of senior loan officers, domestic banks and US branches and agencies of foreign banks reported easing terms for commercial and industrial (C&I) borrowers in the first quarter of 2012. This is a trend that has been seen over the past 6 quarters. It was also reported that demand for such loans also increased. The report also makes note of increased competition for loans by C & I lenders as a driving force for easing credit standards. Although there is evidence of easing credit, gaps remain within the marketplace and within certain industries, and there are also gaps when looking at the size of small business loans being extended. These gaps are being affected by individual bank appetites to extend credit. SBA loan programs are designed to bridge the gaps being seen and felt in the marketplace. For example, we recently improved the CAPLines program to address the working capital needs of our small business borrowers, and are seeing higher demand for this product than we have in the past. We believe this indicates that our programs are helping to fill the gap and that small business lending is increasing.

**23. During the hearing Congresswoman Herrera-Beutler inquired about a business who applied for a loan with a SBA-authorized guaranteed lender. The lender first gave a line of credit while it supposedly worked to process the application (including requesting and receiving supplementary information from the small business owner) and then converted that line of credit in to a high-interest term loan. Do you believe that this is appropriate behavior by a bank?**

SBA would not be able to respond to this question without knowing more details of the transaction and individual situation.

**23a. How much discretion does a lender have when it comes to deciding whether to make a loan?**

The lender determines whether it will approve a loan to a small business applicant and under what terms and conditions. If the lender is unable to approve the loan within its own conventional loan policy, the lender will request a guaranty from SBA. Typical reasons for requesting the SBA guaranty include, but are not limited to, the applicant needs a longer maturity than the lender's policy will permit (for example, the business needs a loan that is not on a demand basis) or the requested loan exceeds either the lender's legal lending limit or policy limit regarding the amount that it can lend to one customer.

**23b. What regulations or standard operating procedures exist to prevent a lender from falsely claiming that it is processing an application to the SBA and then not submit an application?**

If a lender were falsely claiming to be processing an SBA application, SBA would not have any firsthand knowledge of the matter unless the SBA were contacted directly by the small business applicant inquiring about the status of an individual application. SBA is not a party to the transaction until a request for a guarantee is submitted to SBA by the lender.

**23c. What enforcement actions are available for the SBA to take against lenders who conduct this type of "bait and switch"?**

Until the SBA receives an application and request from a lending partner for a guarantee by SBA, SBA is not a party to the transaction. If the SBA were to become aware of fraudulent activities on the part of a lending partner, a referral to the Office of the Inspector General would be the appropriate course of action, along with consideration of other supervisory or enforcement action.

**24. During the hearing, Congressman Mulvaney asked whether SBA is seeing any trends in reasons for taking enforcement action against lending partners and other financial assistance program participants, users or loan packagers. Please detail the top reasons for taking enforcement actions, any trends with respect to enforcement and what SBA is doing to address this behavior.**

SBA is monitoring for trends in potentially risky behaviors. Increasing trends/reasons for taking supervisory or enforcement actions include for example where SBA Lenders i) are under a regulatory order by its Federal Regulator; ii) have a high percentage of loans sold on the secondary market; iii) stop servicing their portfolio; iv) have high growth (double digit) portfolios, v) have declining SBA credit scores, and vi) have high rates of early loan default rates. Many of SBA's lending institutions have been hit hard by the recession putting pressure on capital assets and reserves. As a result many banks are under Regulatory Orders unrelated to SBA loans but of concern to SBA because of the potential risk to the SBA portfolio. SBA is also seeing that, in order to maintain liquidity, lending institutions are selling more SBA loans into the secondary markets, increasing risk to SBA. Some SBA Lenders sell 100 percent of their SBA portfolio into the Secondary Market. If these loans default, SBA must pay the investor prior to performing a purchase review of the loan. As we see these risk trends emerge, we move to increase oversight or take supervisory action (e.g., corrective actions, perform secondary market loan sale evaluations, restrict renewal of delegated authorities, perform targeted reviews).

SBA is also increasing its supervision of lender reporting requirements and other compliance deficiencies as we increase focus on maintaining program integrity.

**STATEMENT**

by

# The National Association of Development Companies

on

**The Small Business Administration**

## Office of Credit Risk Management Planning

Submitted to the

## COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

**UNITED STATES**

**HOUSE OF REPRESENTATIVES**

by

**Christopher L. Crawford**
President & CEO

McLean, VA.

June 6, 2012

The National Association of Development Companies (NADCO) is pleased to provide this statement to the House Committee on Small Business regarding the work of SBA to expand and improve its regulation and oversight of the CDC loan guarantee program (also known as the SBA 504 program) through its Office of Credit Risk Management (OCRM). The purpose of this program is to promote business expansion and job creation through the provision of long term funding to growing small businesses at fixed interest rates and low equity injection by borrowers.

NADCO is a professional membership organization representing the Certified Development Companies (CDCs) responsible for the delivery of the SBA's CDC program. We represent more than 250 CDCs with over 800 offices, and 250 affiliate members. Our CDC members provided more than 95% of all long term 504 financing to small businesses during 2011, as well as many other small business financial assistance programs and job creation services in their communities.

CDCs are for the most part not-for-profit intermediaries with a statutory mission to provide community and economic development through the delivery of this SBA loan program and other economic development programs and services customized to the needs of their respective communities. Our goal is to help small businesses create and retain jobs through their growth.

The purpose of this statement is to provide our industry's concerns about lending regulation and oversight, and to inform the Committee of our perception of the need for, and current status of, changes in the oversight and enforcement plans within SBA's Office of Credit Risk Management.

**A Brief History**

Certified Development Companies are "certified" and authorized by the SBA to provide local access to the 504 loan guarantee program created by SBA in 1986. CDCs were actually authorized by Congress as Local and Statewide Development Companies through the Small Business Investment Act (SBIA) in the late 1970's, and began as local community-based lenders utilizing the 502, then 503 loan programs.

In 1986, the program migrated from being funded (for 503 projects) by the Treasury's Federal Financing Bank to obtaining funds through the sale of debentures that were guaranteed by the Small Business Administration under the SBIA. This meant that the Federal Government no longer had to budget for the funding to make these loans, but instead could budget for the subsidy cost of these loans, or roughly, the cost of the loan losses due to small business defaults.

In the early to mid-2000's, SBA concluded that it's then-current means of evaluating CDC lending performance and overseeing their 504 lending activities were insufficient to insure continued acceptable loan portfolio performance. SBA created the Office of Lender Oversight, and began a two-pronged approach to this new mission.

First, a contract was awarded to Dunn & Bradstreet to require that firm to use its non-financial small business information data base to evaluate the borrowers using the CDC loan program, and to forecast the likelihood of default by borrowers. Our industry was concerned about this

methodology, as it virtually ignored the wealth of actual borrower financial and tax data already available through other SBA contractors such as the Central Servicing Agent, Trustee bank, and the extensive loan files maintained by the lending CDCs.

Second, SBA retained a small Virginia CPA firm to staff up a new process to perform "field reviews" of CDC's loan portfolios on a sampling basis. Again, our industry had significant concerns about this, as few of these individuals had lending, credit, or 504 experience. Most were either CPAs or other financial management personnel. Further, these reviews proved to be little more than going into a CDC to pull about thirty loan files and check that a fixed list of loan documents were in those files. There appeared to be no concern about the eligibility of those borrowers, nor their actual credit worthiness to obtain a CDC loan, or even the current status of the loan payments by the borrowers.

Our industry repeatedly met with senior SBA officials, including those in the OIG, to express concerns about the inadequacy of the reviews and oversight by the Office of Lender Oversight, which evolved into the Office of Credit Risk Management. Eventually, following restructuring and personnel changes, SBA arrived at today's OCRM structure.

**Current Situation**

We find today a very different, and highly constructive, environment within the Office of Capital Access and the Office of Credit Risk Management.

With recent management changes, and the award of new contracts to perform both lender risk ratings and field reviews, NADCO believes that SBA is now on the right course to more appropriately evaluate CDC lending performance, internal operations, and portfolio performance. We also believe that SBA now has the regulations and policies in place, and the management team qualified to provide needed enforcement of appropriate lending policies set within Capital Access.

We are convinced that, if management is provided with requested funding and experienced personnel, lending practices that have led to unwarranted loan defaults will be identified and stopped, and the CDC industry will be provided with clear performance guidelines, which if crossed, will result in necessary enforcement actions.

**Recommendations for the Future**

Provided below are further recommendations that may further enhance OCRM's work to insure that CDC loan program portfolio quality is improved and maintained so that the current subsidy cost of the program may be reduced or eliminated.

1. Consider use of SBA staff for CDC on-site reviews, rather than contractor personnel: SBA has spent substantial funds in developing contract RFPs, bidding out these field services, paying external contractors, and overseeing their resources and service levels. NADCO believes that it may be feasible to not only reduce the overall costs of OCRM field reviews of lenders (PLP 7(a) lenders now pay at least $25,000 per week for review

teams to be on-site), but also improve on a service level that has been mixed, at best, for multiple contractor firms. This would also stabilize the personnel and improve their skills over time in reviewing complicated credit transactions and extensive loan files maintained in CDCs for all borrowers. These same Federal employees would be available to perform "desktop" reviews of all CDC lenders when between field reviews.

2. Provide clear and easily understood lending policies: Today, the regulations, SOPs, Notices, and "unwritten" rules have become extremely complex. Moving to an annual major SOP update has helped, and we encourage SBA to continue to seek ways to simplify loan policies so that CDCs, borrowers, banks, and even SBA personnel can understand the program's parameters.
3. Provide clear and transparent oversight and loan portfolio quality parameters: Lenders can only adhere to rules and regulations that they understand. This begins with policies that are commercially applicable, clearly documented, and understood by every participant. SBA is not there at this time, but the industry is hopeful that new management will move towards better performance evaluation systems and measurements. Again, these must be understood by every program participant.
4. Provide opportunities for public and industry input on new evaluation methods and performance measures: SBA today has two completely separate CDC performance evaluation processes. These all-to-frequently provide results that are inconsistent between the two, thus confusing CDCs, banks, and governing boards of directors. Our industry strongly advocates that one consistent and detailed system be utilized that is easily understood, and that the agency is open to continuously reviewing and improving as needed to focus on performance issues within the industry.
5. Utilize existing data already available to SBA: CDCs already collect on-going tax and financial data from borrowers for all 504 loans. Additionally, CDCs provide annual reports to SBA that contain Form 990's, which provide very detailed financial reporting on CDC operations. SBA also has direct access to portfolio performance data from other contractors, including the Central Servicing Agent and the program Trustee bank. OCRM should have access to this information to evaluate both CDC and loan portfolio performance, and insure CDC adherence to lending policies. Finally, OCRM should have access to ASM CDC reviews now conducted by the SBA's Sacramento Loan Processing Center, as well as Quality Assurance Reviews and Complete File Reviews conducted by the SBA's District Counsels at loan closing.
6. Identify loan portfolio problems early: OCRM should use consistent "desk top" portfolio reviews, as well as "on-site field" reviews to evaluate CDC performance. Again, we are hopeful that SBA is moving in this direction, but it is early in the reconstruction process at this time. SBA should do all it can to monitor loans as they are put into the 504 portfolio to catch delinquency and default issue quickly. This should include "aging" of delinquencies on a regular basis; something we are not aware of SBA doing today.

**Conclusion**

Our industry is very pleased that current SBA management appears to be moving aggressively to address the shortcomings now inherent in the OCRM CDC review process. SBA has been open to recommendations and comments to this point, and we see a completely difference viewpoint of new management towards needed industry oversight.

NADCO looks forward to continuing to work with SBA to improve and implement their new procedures, and we are hopeful that this work will result in an improving portfolio performance and reduced costs to the taxpayer.