TESTIMONY OF

ADMINISTRATOR STEVEN PRESTON

United States Senate

Small Business and Entrepreneurship Committee

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Chairman Kerry, Ranking Member Snowe, distinguished members of the Committee, thank you for inviting me here today to discuss the Small Business Administration's ongoing efforts to assist entrepreneurs throughout the country through the Agency's various lending and investment programs. In particular, I would like to discuss SBA's efforts in the area of credit risk management and the important responsibility we have in managing program credit risk, monitoring lender performance, and enforcing lending program requirements. I will also discuss SBA's requested redactions to a recent Inspector General audit report.

SBA manages a portfolio of over $80 billion, a portfolio that has grown significantly through the PLP program and since the expansion of the SBA Express program. This growth demonstrates SBA's success in reaching more small businesses and presents challenges with regard to our risk management responsibilities. We have made significant progress in putting measures into place to oversee risk in the loan programs, while increasing the number of small businesses that we are able to assist through these programs.

<u>Background</u>
SBA administers its 7(a) loan guarantee program through participating banks, credit unions and other lenders including, for example, Small Business Lending Companies (SBLCs). These lenders receive varying levels of delegated authority from SBA to make 7(a) loans. For example, under the Preferred Lender Program (PLP), SBA delegates loan approval, closing, and most servicing and liquidation authority and responsibility to PLP lenders. This program was established by Congress to streamline these processes. SBA is currently responsible for oversight of approximately 5,000 7(a) lenders, 640 of which have PLP authority.

In 2003, a Government Accountability Office (GAO) report noted that SBA had made significant progress in developing its lender oversight program, but that more effective oversight was necessary, particularly of PLP lenders. In particular, GAO recommended that SBA adequately measure the financial risk to SBA of lenders' SBA portfolios, that SBA perform qualitative assessments of lenders' performance and lending decisions, and that SBA clarify its enforcement authority and specify enforcement conditions.

Since the issuance of the 2003 GAO report, SBA has taken important steps to put into place a comprehensive credit risk management program for its loan programs. These steps include:

- Implementing a comprehensive off-site review/monitoring program which features sophisticated risk rating measurements developed by a nationally-recognized provider of commercial credit scoring solutions;
- Instituting a risk-based on-site review/examination program that includes qualitative analysis of a lender's credit administration, SBA operations management, and loan portfolio performance data;
- Drafting proposed lender oversight and enforcement regulations; and
- Developing a coordinated and more independent supervision and enforcement process.

These actions are just a part of SBA's ongoing process of increased and expanded portfolio oversight that SBA began implementing in the last several years. A more detailed discussion of our progress follows.

Oversight

To monitor portfolio problems, SBA relies on both on-site and off-site reviews of the lenders. To facilitate off-site reviews, SBA has contracted with a nationally-recognized provider of commercial credit scoring solutions and predictive performance models. This provider has a strong track record within the financial services industry. The information they provide on a lender is compared with other lenders of similar size and portfolio makeup. Information is shared with the lender, and provides the lender with a peer group understanding of their performance and status within SBA's portfolio. SBA also uses this information to assign lenders with a risk rating based on the individual loan information and overall portfolio information, as indicator of portfolio performance. This enables SBA to take corrective action.

SBA on-site reviews are conducted with lenders to provide more in-depth reviews of individual loans, pulled at random, and checks on lender adherence to SBA policies and procedures. In the case of those lenders supervised primarily by SBA (SBA Supervised Lenders), SBA contracts with an independent examiner, the Farm Credit Administration, to provide in-depth on-site safety and soundness and portfolio performance evaluations.

In addition, SBA can reduce the time period between renewals of delegated lending authority. Shortened renewals are another means of mitigating SBA risk. SBA also has the ability to conduct more frequent on-site reviews, and the ability to work with the lenders' management to resolve deficiencies. Corrective action plans can include quarterly monitoring. In addition, a wide range of data is collected that provides SBA with continual updates on lenders' progress. These are substantial reforms that allow lenders to remedy deficiencies in their loan portfolios while continuing to serve the small business community.

When deciding which corrective measures to take for under-performing lenders, SBA seeks to efficiently meet programmatic objectives while first and foremost, protecting the taxpayer.

The progress that we have made in lender oversight demonstrates that SBA is taking its responsibility very seriously. In addition to our responsibilities for general oversight, we are considering how to lessen the likelihood of fraud in our loan programs. While fraud occurs generally by exception, SBA nevertheless is taking measures to prevent its occurrence. To that end, SBA is working cooperatively with its lending partners to ensure that they have in place policies and procedures to identify and prevent fraudulent activity. In addition, SBA is working to identify irregularities in lenders' portfolios and to bring these to the attention of SBA's Inspector General (OIG). SBA relies on SBA's OIG and the Justice Department's experts in fraud to investigate and prosecute fraud related activities. While we have processes and policies in place to deal with these issues, SBA is considering what other analytical tools SBA can add to facilitate fraud detection.

Proposed Regulation

On October 31, 2007, the Agency published a lender oversight proposed rule. This proposed rule would further establish the roles and responsibilities of SBA's Office of Credit Risk Management, while codifying more comprehensive and coordinated oversight regulations for participants in SBA's loan programs.

While this proposed rule would codify many of the processes that SBA has already developed, especially in the area of on-site and off-site reviews/examinations and risk ratings, it also provides for new enforcement actions available to SBA, new oversight processes, and the implementation of new controls, especially for SBA Supervised Lenders. The proposed rule also would address GAO's recommendation to provide clear policies and procedures for taking enforcement actions against lenders in the event of continued noncompliance with SBA requirements. In addition, it would more precisely specify that 7(a) lenders must maintain a level of satisfactory portfolio performance.

In addition, the proposed rule would enhance reporting requirements for SBA lenders, especially SBA Supervised Lenders (specifically SBLCs and Non-Federally Regulated Lenders). This would greatly assist SBA in monitoring lenders and assessing lender performance.

SBA is awaiting comments on the proposed rule from interested members of the public. We will carefully consider any comments we receive in developing a final rule that thoughtfully implements SBA's lender oversight responsibilities.

IG Report

As you know the Agency has moved quickly to recover any losses stemming from the loan fraud investigation involving BLX's former Michigan office manager that was uncovered by the U.S. Secret Service, the U.S. Attorneys Office in Detroit and our Inspector General's Office. That action included a written agreement with BLX that provided SBA with compensation for known losses stemming from the fraud and an additional obligation to cover any losses revealed in the future. It also provided for the retention by the Agency at BLX's expense of a large accounting firm experienced in forensic accounting to review all BLX PLP loans prior to their sale into the secondary market and, if there is a default in one of their loans once it is in that market another review by the accounting firm before SBA pays on its guarantee.

Recently, the Office of the Inspector General issued an audit report regarding SBA's credit risk practices, which focused largely on BLX. The OIG has provided this Committee with an un-redacted copy of the report. The OIG has also made a copy in redacted form available on its website. The needs for the redactions have been detailed in my letter to the Committee of November 6, 2007. Briefly stated, the redactions are the necessary result of the delicate balance SBA must strike between full public disclosure and protecting the integrity of the Agency's duties as a financial regulator. The public disclosure of such information would severely damage the Agency's ability to obtain sensitive or adverse information from its lenders. Keeping such information confidential is standard practice among financial regulators. Indeed, the legend placed on audit reports of SBA lenders by our contract auditor, the Farm Credit Administration, warns of criminal penalties for violation of the confidential nature of such reports. Furthermore, Congress and the courts have recognized the there is a need in government for protecting the confidentiality of information that comes under the bank examination privilege, the deliberative process privilege and the matters exempt from disclosure under the Freedom of Information Act.

Review/Examination Fee

SBA realizes that as the Agency modifies and strengthens its oversight activities, our industry partners will have questions and concerns. For instance, when SBA first instituted our lender oversight fees some lenders objected. However, the purpose of the fees was fully described in our proposed regulation and industry comments were carefully considered and addressed in the final rule. These fees enable SBA to perform on-site and off-site risk management on the 7(a) loan portfolio. The amount of the oversight fees charged to the lender is a progressive system linked to the size of the lender's portfolio. As such, many of our lending institutions have portfolios that are so small that they will not be charged any fee. This structure considers the amount of risk SBA is exposed to relative to the lender's activity in the 7(a) program. For those financial institutions regulated and examined by other banking regulators, the SBA fees are modest in comparison. For SBA Supervised Lenders, the SBA fees are critical to ensuring that proper safeguards are in place and they are commensurate with the examination fees charged by banking regulators generally.

For the off-site review, SBA charges an annual fee of $73 per million dollars in portfolio size. Through these reviews, SBA receives information on the lenders' SBA portfolio performance and is able to share the bulk of the information with lenders. We have provided lenders with the factors that comprise the risk rating calculations and their individual component ratings. We also have provided them with peer group and portfolio averages for the component ratings. The information obtained through the off-site review is but one of many tools that SBA uses to oversee its loan portfolio and its participating lenders.

SBA is particularly conscious of the regulatory burdens placed on small businesses and as such is sensitive to the need to minimize fees whenever practicable. However, the fees charged to lenders are necessary for protection of the taxpayers. The oversight fees charged to lenders are fully detailed in the Lender Review Fee notices that SBA has published. The notices provide a breakdown of how on-site and off-site review fees are calculated. This breakdown shows that the fees are based on the actual costs to the Agency, and are not a substitute for the administrative costs of the program.

Finally, through SBA reviews and examinations, we expect to decreases risk and can improve portfolio performance, however it is conceivable that unexpected factors such as change in the loan mix and other factors could increase risk..

Mr. Chairman, SBA has made significant progress over the past several years to improve and increase the oversight we perform on our guaranteed loan portfolio. SBA believes this strengthened management is crucial to the operation of a modern guarantee portfolio.

I would like to thank the Committee again for the opportunity to discuss progress in SBA's credit risk management program and I look forward to continuing to work with the Committee to assist our Nation's small businesses.