The SBA Express Pilot Program

June 1998

INSPECTION REPORT

No. 98-06-01

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BACKGROUND

SBAExpress (formerly FA$TRAK) was established on February 27, 1995, as a pilot program to test the concept of granting selected banks from the Preferred Lender Program (PLP) additional authority and autonomy in approving SBA guaranteed loans in amounts up to $100,000. Eighteen banks or bank holding companies originally volunteered to participate in the program,[1] which will continue as a pilot.

SBAExpress was initiated to increase the capital available to small businesses by permitting lenders to use their existing documentation and procedures while receiving a reduced SBA guaranty on loans of $100,000 or less. Specifically, participating lenders are allowed to use their own application forms, internal credit memoranda, notes, and other documentation pertaining to collateral, loan servicing and liquidation. Lenders follow their own underwriting procedures and are authorized to attach an SBA guaranty to a loan without having to submit it to SBA for review. In return for this autonomy, lenders agree to limit the loan amount to $100,000, accept a maximum guaranty of 50 percent, and waive payment on defaulted loans until after the lender has completed liquidation and SBA has reviewed the underlying documentation supporting the loan.

Data from the Office of Financial Assistance (OFA) show that from February 1995 through September 1997, the participating lenders made 7,327 SBAExpress loans valued at $327.6 million. The average size of an SBAExpress loan was $47,378. The three most active bank holding companies, taking into account recent mergers and acquisitions, accounted for 3,870 SBAExpress loans, or 53 percent of the program's total lending activity.

In April 1998, OFA made several changes to SBAExpress, including extending the program as a pilot until September 30, 2001, increasing the maximum loan amount to $150,000, requiring that all available collateral be secured for loans greater than $25,000, expanding eligibility to include other active PLP lenders, requiring participants in the program to adopt general 7(a) portfolio goals to address underserved markets, and permitting the sale of SBAExpress loans on the secondary market.

[1] The program started with 18 PLPs, but subsequent mergers reduced it to 14 lenders.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objectives of this inspection were to review the lending practices of SBAExpress lenders and identify any (1) loan underwriting practices that may not be consistent with the objectives of the pilot program, (2) additional guidelines or controls needed to strengthen SBAExpress lender oversight, and (3) other program issues that emerged during the inspection that may warrant attention.

The inspection originated with an inquiry sent to the Office of Inspector General (OIG) by an SBA district counsel, who suggested that the OIG review the loan underwriting practices of a bank following the request for SBA purchase of three of its eleven SBAExpress loans. Additionally, the inspection addresses the concerns of Senators Patrick Leahy and James Jeffords, who in a December 9, 1997, letter to Administrator Alvarez requested that SBA ". . . review the underwriting practices of SBAExpress lenders."

The SBAExpress pilot program began in February 1995. The relatively short time it has been in operation and the small number of participating lenders necessarily limited the scope of the inspection. The fact that loans generated via SBAExpress were not yet seasoned[2] precluded useful findings about the program's potential impact on SBA's subsidy rate. Given these considerations, along with the significant changes announced for the program while the inspection was in progress, we decided to restrict this inquiry to gathering feedback from the perspective of the participating lenders. We plan to take a more comprehensive look at SBAExpress performance after the program has had sufficient experience under the new guidelines to provide a track record to examine.

In March 1998, the team conducted a survey of the 14 current SBAExpress lenders (see Appendix A). The questions, which focused on lending practices and individual experiences with SBAExpress, were formulated based on interviews with OFA headquarters staff, SBA field personnel, and four active SBAExpress lenders. We pretested the survey with two active SBAExpress lenders; the results of the final survey and follow-up interviews were used to evaluate potential vulnerabilities in the program.

In reviewing legal requirements for the SBAExpress program, the team relied on OIG counsel to provide legal interpretations of laws, regulations, and standard operating procedures governing SBAExpress lenders. We also consulted with SBA's Office of General Counsel.

The team met with four of the larger SBAExpress lenders to discuss their general banking practices for originating and servicing small business loans, how SBAExpress fit into their lending strategies, and what they thought were the program's strengths and weaknesses. We also asked for any suggestions they had for improving the program.

All work on this inspection was conducted between December 1997 and April 1998 in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

[2] For purposes of this report, "seasoned" loans are loans that are at least three years past the date of origination. Statistically, many loans that become delinquent do so in years 3-5; therefore, reliable currency data generally cannot be calculated from a portfolio of loans that is less than three years old.

FINDINGS

1. From the perspective of the participating lenders, SBAExpress has been effective in meeting both its objectives and the needs of the lenders and borrowers.

Our survey of the SBAExpress lenders indicates that they consider the program highly effective, particularly in reducing the time and paperwork in originating an SBA loan, in addressing a small business demand not formerly met, and in increasing banks' use of SBA-guaranteed loans. On a one-to-five scale, with "5" indicating "very effective," lenders gave the program an average rating of 4.5. They stressed that they need the kind of freedom and flexibility provided by SBAExpress, noting that the program allows them to originate loans where cash flow or debt/equity ratios do not meet the bank's normal lending standards. The lenders also indicated that the program helps them penetrate traditionally underserved lending markets, such as those for women and minorities. For example, one stated that SBAExpress helps meet a need in these markets by providing a vehicle for short-term flexible financing. The lender explained that many small businesses in traditionally underserved markets are start-ups, with little or no financial history, that are seeking small revolving lines of credit. Before SBAExpress, his bank could only offer SBA term loans, which lacked the flexibility required by these businesses. The survey indicated that revolving lines of credit are in demand in all sectors of the small business market, and many of the lenders felt that SBAExpress is the most efficient SBA program available for providing such lines.[3]

From the lenders' standpoint, SBAExpress seems to be meeting its primary objective of increasing the capital available to small businesses. One lender we interviewed indicated that his bank's volume of SBA loan originations over the past five years has doubled, and he attributed much of that increase to the introduction of LowDoc and SBAExpress. He said that preferences had shifted significantly from term loans to revolving lines of credit. Five years ago, 80 to 90 percent of his bank's SBA loan production was in PLP term loans, while today such loans are down to around 50 percent, with SBAExpress and LowDoc each accounting for approximately 25 percent of loan originations. He predicted that because of its flexibility, SBAExpress will capture a higher percentage of future SBA loans. The lenders value, in particular, the incentive of using their own documentation and procedures in originating small loans backed by the lower SBA guarantee.

2. It is not clear whether credit scoring alone is sufficient to meet SBA's requirement for a "thorough and complete credit analysis."

According to the SBAExpress Program Guide, lenders are responsible for conducting a "thorough and complete credit analysis" that demonstrates that the loan can be repaid from the cash flow of the business. However, SBA regulations and SOPs neither define what constitutes a thorough and complete credit analysis nor indicate whether credit scoring alone is sufficient to meet this requirement for loans up to a certain size.

Increasingly, lenders are turning to automated underwriting methods such as credit scoring to improve the efficiency of their underwriting processes. These approaches have special appeal in the case of small loans, where reduction of overhead can be a significant factor for the lender. Approximately two-thirds of the lenders reported that they are using credit scoring, in combination with other types of analysis, for SBAExpress originations and are satisfied with it as an indicator of loan repayment ability. One lender indicated that it used credit scoring exclusively in the case of many small business loans; another told us that credit-scored loans at his bank had actually performed better than those where credit decisions had been based on traditional financial

[3] Revolving lines of credit are also available through SBA's CapLines program. Lenders noted, however, that many of that program's monitoring and reporting requirements are too cumbersome and/or costly for smaller loans.

analysis. Fair, Issac & Co., whose small business credit scoring system appears to be the most widely used, now has about 275 bank customers, and the demand for its product continues to grow. The system has been used by SBA as a supplement to a traditional financial analysis in the LowDoc program since September 1997.

The current SBAExpress rules and regulations do not address the issue of credit scoring, despite its growing popularity in the banking industry. It is clear from the comments of lenders participating in the program that they need guidance on the acceptability of such automated underwriting methods.

3. Language governing the requirements of promissory notes for SBAExpress loans is ambiguous.

One District Counsel recently found that three loans that had been submitted to his District for purchase from a lender did not include promissory notes among the closing documents. Rather, the loans were originated as unsecured lines of credit backed solely by a personal guarantee.

In documents supporting the District Director's request for denial of the guarantee on the three loans, the District Counsel argued that by failing to execute a promissory note, this lender was in violation of SBA rules and regulations governing the program. He based his conclusion on several sources, including the SBAExpress Program Guide, which states, ". . . lenders are permitted to use their own closing documentation. This documentation includes, but is not limited to, the lender's note."[4] In addition, the SBAExpress Loan Authorization Form states that, ". . . authorization is subject to . . . the following terms and conditions: . . . (2) Execution of a note."[5] Language in the SBAExpress Supplemental Guarantee Agreement, as well, states that, "Lender shall be permitted to use its own . . . note."[6]

SBA's Office of General Counsel, however, had a different interpretation of the language pertaining to promissory notes. In a January 1997 memo on bank documentation and loan processing practices, it states that, " . . . documentation representing the debt obligation of a small business [that the lender submitted] with its purchase request is considered to be the equivalent of a traditional note and should be treated . . . as such."

We reviewed both opinions with several members of OIG's legal counsel, who noted that the language currently used in the Federal Register, the Program Guide, and SOPs referring to the use of a promissory note is ambiguous. Given the way the program is currently structured, however, they also believe that lenders cannot be denied SBA's guarantee for originating a loan using documentation they normally use for non-SBA loans of similar size and type. If it is the lenders' normal practice, therefore, not to use a note in such loans, the SBA Express guidelines may not be sufficiently explicit on the matter to deny purchase of a SBA Express loan due to the absence of a note. SBA needs to clarify its policy for notes in the program.

OTHER ISSUES

Use of credit cards. One participating bank issues a credit card with all of its revolving lines of credit, including those originated under SBAExpress, because it provides a convenient way for a business to access its line. Operationally, this business credit card works like a consumer credit card except that there is no grace period for repayment. Rather, finance charges begin accruing immediately upon making a purchase. There is some risk that

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[4] SBAExpress Program Guide, VI, D (1)
[5] SBA Form 1920 (2/95)
[6] Federal Register, Vol. 60, No. 43, p. 12269

a business borrower might violate the loan agreement by charging personal items on the credit card, but the risk does not appear to be any greater than using a check, which is the standard instrument for revolving lines of credit. Neither a credit card nor a check provides effective monitoring of how the funds are actually spent. As in all lines of credit, misuse of SBAExpress funds is difficult to detect because the lender is unable to identify at the time of purchase whether goods and services are business-related.

At this point, only one SBAExpress lender is using credit cards, but in light of questions posed by other current lenders, we believe that the Agency should provide written guidance to clarify the matter. An SBA district counsel suggested that the Agency decide the appropriateness of SBAExpress lenders issuing credit cards and determine whether a credit card agreement signed by a business principal receiving a Government-guaranteed line of credit shall be considered a promissory note by SBA. Such clarification would benefit both district officials and participating lenders by providing clear guidance regarding the issuance of credit cards with lines of credit originated under SBAExpress.

<u>Program rules and regulations</u>. Currently, there is no single source to which a lender can turn for guidance to find the regulations and standard operating procedures that apply to the SBAExpress pilot. Rather, lenders have to cross-reference the <u>Code of Federal Regulations</u>, the Loan Guarantee Agreement, the SBAExpress Supplemental Guarantee Agreement, the SBAExpress Program Guide, the SOPs, the <u>Federal Register</u>, and the SBAExpress Loan Authorization Form to determine how to implement the program in compliance with SBA directives. This process is cumbersome and still leaves many issues open to interpretation. It can also create a fundamental conflict between SBA's advertising of the program to lenders as a faster way to originate more loans with less regulatory burden and the Agency's requirement that these lenders ensure that their processes and documents comply with myriad SBA rules and regulations. Participating lenders flagged this problem in our survey. One, for example, commented that SBA " . . .should update program guidelines and address the use of unsecured debt." Another mentioned that the Agency should ". . . standardize parameters on what is acceptable for bank's utilization of (the program) via credit scoring."

CONCLUSION

The participating lenders clearly are enthusiastic about SBAExpress, but OFA needs to strengthen and clarify language in its rules and regulations. The fact that the current language leaves room for interpretation creates confusion for both lenders and SBA district officials. There are two areas where it is especially important to clarify governing language: (1) whether credit scoring methods alone satisfy SBA's requirement for a "thorough and complete credit analysis," and (2) whether SBA should require SBAExpress borrowers to sign a promissory note with specific provisions even if the lender's regular practice for loans of similar size and type is to require only a signed personal guarantee.

RECOMMENDATION

1. **The OIG recommends that the Associate Administrator for Financial Assistance clarify the rules and regulations pertaining to the use of credit scoring and promissory notes in SBAExpress loans.**

APPENDIX A

RESULTS OF SBA IG SURVEY ON LENDER USE OF SBAExpress

1. How effective has the SBAExpress program been in each of the following? (Circle one)

	Not effective				*Very effective*
Reducing the paperwork required for an SBA loan	1	2	3	4	5
Reducing the time required to process an SBA loan	1	2	3	4	5
Addressing a small business demand formerly not met	1	2	3	4	5
Increasing your bank's use of SBA-guaranteed loans	1	2	3	4	5

- *On reducing paperwork, survey participants gave SBAExpress an average rating of 4.7.*
- *On reducing time, survey participants gave SBAExpress an average rating of 4.6.*
- *On addressing a demand, survey participants gave SBAExpress an average rating of 4.4.*
- *On increasing use of SBA loans, survey participants gave SBAExpress an average response of 4.4.*
- *Together, these responses indicate that SBAExpress is perceived by these lenders as a highly effective program.*

2. Please estimate the percentage of SBAExpress loans in which the following delivery methods are used.

63%	Revolving line of credit
11%	Installment loans
26%	Term loans
0%	Other (specify)____________________
100%	

- *One of the respondents marked 6% for "Other (specify)," explaining that his bank originates approximately 6% of SBAExpress loans as mortgages, using for collateral the personal residence of the small business borrower. (This rounds down to less than one-half of one percent when calculating the average of all the responses.)*

3. When do you normally use SBAExpress rather than another SBA product, such as LowDoc, CAPLines, or regular 7(a)?

- *Revolving lines of credit, which were mentioned by 8 of the 14 respondents, were the most frequently cited reason for choosing SBAExpress over other SBA products. (In interviews, lenders described CAPLines as overly burdensome in the documentation and oversight required to make and service the loan.)*
- *Other responses for use of SBAExpress included the following: when the applicant has a low debt/income ratio, when the applicant's business has been operating for less than three years, when the application is for a term loan below $50,000, when collateral values are strong, on loans for "an established business" when the borrower is an existing business with a good operating history, and when the applicant is an "exceptional applicant."*

- *Another respondent favored SBAExpress because "portfolio management and monitoring requirements are kept to a minimum," approval is under delegated authority, and SBA underwriting is unnecessary.*

4. (a) Does your bank use credit scoring to evaluate SBAExpress loans?

Yes *71%* No *29%*

(b) If yes, please estimate the percentage that are evaluated using credit scoring___________%

(c) How satisfied are you with credit scoring as an indicator of loan repayment ability for SBAExpress loans? (Circle one)

Not satisfied at all *Completely satisfied*

1 2 3 4 5

- *Of the ten respondents who reported using credit scoring , the median percentage of SBAExpress loans evaluated using credit scoring is 98%.*
- *Of the ten respondents to 4(c), nine circled "4" or "5" and one marked "3," indicating that participants have been quite satisfied with credit scoring as an indicator of loan repayment ability for SBAExpress loans.*

5. Does your bank perform a regular financial analysis/risk analysis (outside of credit scoring) on each SBAExpress loan ?

Yes *79%* No *21%*

6. Is credit scoring alone sufficient for evaluating whether a SBAExpress loan should be made?

Yes ____ No____ Please explain.

- *Seven of the respondents checked "Yes," with one of them commenting that "when building the score card it can be determined by historical analysis of past statistics how well a loan will perform and how well the portfolio will perform."*
- *Four of the respondents checked "No," and variously cited internal bank policies, the need for a basic cash flow analysis to support debt repayment ability, the need to consider collateral position, or the need to meet SBA SOPs and eligibility guidelines as loan-making criteria requiring human intervention beyond credit scoring.*
- *These responses indicate that while banks may be increasing their use of credit scoring to analyze creditworthiness, particularly for smaller loans, most are still reluctant to rely on it exclusively for underwriting decisions.*

8. (a) At what loan amount, if any, should collateral be used to secure a SBAExpress loan? $_______________ Please explain.

- *Responses to this question varied significantly, with no apparent consensus. One respondent thought the amount should be $10,000, another $25,000, another $35,000, two others $50,000, and another $100,000. One respondent indicated that it always took collateral on SBAExpress loans or lines, while another respondent merely said "it depends."*
- *One lender noted that the cost to administer collateral is often prohibitive for loans of less than $50,000.*
- *Overall, these responses were inconclusive, suggesting that further analysis may be necessary to determine the appropriate loan amount at which collateral should be required for securing a SBAExpress loan.*

(b) What estimated percentage of your SBAExpress loan portfolio is secured by the following:

__*100%* Personal guarantee
___*21%* Lien on personal assets
___*84%* Lien on corporate assets
____*0*% Unsecured

- *All the lenders require at least a personal guarantee for SBAExpress loans. Just one lender requires only a personal guarantee and only on loans of less than $50,000. Most lenders also require liens on personal or corporate assets, but the lenders listed highly variable percentages for these categories, ranging from 2% to 100%.*
- *On average, 21 percent of SBAExpress loans are backed by a lien on personal assets.*
- *On average, 84 percent of SBAExpress loans are backed by a lien on corporate assets.*
- *Only two lenders indicated that any of their SBAExpress loans were unsecured; one noted that its percentage of unsecured SBAExpress loans was only 5 percent, and the other lender permits unsecured loans only on loan amounts less than $50,000.*

8. What steps should SBA take to ensure adequate oversight of the SBAExpress program?

- *One lender commented that SBA should "issue guidelines for banks to follow for approval consistency (i.e., when to take all available collateral)." Another lender suggested that SBA "update program guidelines and address use of unsecured debt."*
- *Another lender commented that SBA should continue to restrict the program to preferred lenders and further protect itself by setting a maximum loan loss rate. If a lender surpasses this level, it should be prohibited from further participation in the program. This comment was echoed by at least one other lender who suggested that lenders that had an excessive loss rate could be "pulled" from the program.*
- *Another respondent recommended that SBA periodically audit the SBAExpress portfolio and review each lender's monitoring and credit scoring systems. The lender indicated that perhaps this could be done as part of the regular PLP review. Similarly, another lender suggested that SBA conduct "systematic spot auditing" of PLPs.*
- *Another lender stated that "the 50% guaranty puts the lender at sufficient risk that minimal oversight should be all that is necessary."*

9. Please provide any additional comments on these areas or any suggestions for how SBA could improve the SBAExpress pilot program?

- *Four lenders suggested that the maximum loan amount be increased to $250,000, one suggested a maximum of $150,000, another "at least $200,000," while still another merely stated that "the limits could be raised." One lender added that corporate asset collateral should be required (only) on amounts greater than $100,000.*
- *One lender suggested that SBA discontinue IRS verifications on SBAExpress loans.*
- *Another lender commented that SBA should "standardize parameters on what is acceptable for bank's utilization of SBAExpress via credit scoring."*

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

DATE: June 5, 1998

TO: Tim Cross
Assistant Administrator
for Inspection and Evaluation

FROM: Jane Palsgrove Butler
Acting Associate Administrato for Financial Assistance

SUBJECT: Draft Report on SBAEXPRESS

Thank you for your recent comments and recommendations regarding the SBAEXPRESS Pilot Loan program. We are obviously pleased that SBAEXPRESS generally appears to be meeting its stated objectives. And, we would be happy to meet with you should you require additional information on the program or have other comments or insights you wish to share, but otherwise we are generally comfortable with your preliminary findings.

As you properly note, because the SBAEXPRESS portfolio has not had the opportunity to sufficiently mature, any analysis of the program's ultimate impact on the Agency's portfolio or subsidy rate will continue to be preliminary. However, as you know, much of the quantitative analysis included in our recent 606 to expand the program was based on information that was available at the end of FY 1997. We have recently updated that data, and I have included a summary as an attachment to this document. As apparent, as 1502 reporting problems have improved, SBAEXPRESS currency rates have also significantly improved, although they still remain somewhat below those of LowDoc and the 7(a) portfolio. Still, we believe SBAEXPRESS currency rates will continue to improve as we continue to overcome 1502 reporting difficulties.

Also, as you note, the first phase of the SBAEXPRESS Pilot has raised some issues that could benefit from clarified SBA policy, and we have taken steps to address those issues. Our April 14, 1998 606 clarified many areas, but we have also revised and expanded our SBAEXPRESS Operating Procedures to address concerns raised not only by your office but by our lenders and our field personnel as well. Included among those revisions are the following.

(1) The need to clarify minimum documentation requirements relative to promissory notes: We essentially adopted the OGC's January 1997 opinion that - ....documentation representing the debt obligation of a small business [that the lender submitted] with its purchase request is considered to be the equivalent of a traditional note and should be treated as such...", assuming that documentation is consistent with the lenders' established and proven documentation used for similar size and type non-SBA loans.
(2) The use by SBAEXPESS lenders of credit scoring: We view SBAEXPRESS as a continuing pilot program that was designed (for smaller loans) to streamline, expedite, and reduce the cost of processing an SBA guaranteed loan and to test the implications of those changes on the SBA's currency and subsidy rates. And, we recognize that credit scoring is likely to become increasingly important to a more efficient and expedited loan approval process. We also believe that credit scoring will ultimately prove as reliable as more traditional credit

analysis techniques and will therefore come to be viewed as appropriate for many of SBA's loan programs. As a consequence, while we will continue to closely monitor and test the implications of credit scoring, we have revised our SBAEYPRESS procedures to clarify that credit scoring is considered an appropriate credit analysis procedure for the SBA.EXPRESS program, assuming again that it is normally used by the lender to analyze non-SBA loans of similar size and type.

Our revised SBAEXPRESS procedures, which we will forward for your review shortly, will also address several other issues, including use of unsecured debt, use of credit cards, minimum currency rates for entry and continued participation in the program, required currency in 1502 reporting, periodic reviews (and appropriate findings) by SBA personnel, etc.

Thank you again for your comments and suggestions relative to SBAEXPRESS.

APPENDIX C

CONTRIBUTORS TO THIS REPORT

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