STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

<u>504 Loan Guaranty Program</u>

<u>Lender Oversight</u>

Submitted to the

**COMMITTEE ON SMALL BUSINESS
AND ENTREPRENIURSHIP**

UNITED STATES SENATE

by

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I would like to thank Chairman Kerry, Ranking Member Snowe and members of the committee for the opportunity to speak with you today on this important subject. I am Jim Baird, Executive Director of Bay Area Development Company. I also serve as NADCO Vice-Chair for Legislative Affairs. I would like to submit written comments for the record as well as provide a summary of my comments today on this important issue.

Our industry, as represented by NADCO, has a significant and ongoing interest in maintaining the highest standards of industry oversight and loan program performance. We have previously communicated some of these thoughts to representatives of the agency and to Congress. The association's May 23 letter to the agency on this issue is attached to my testimony for inclusion in the record.

Background

The agency's program of 504 lender and loan oversight is an evolving one. Over the last several years, the responsibility of implementing 504 lender oversight has moved from the District Offices to the Office of Lender oversight (now the Office of Credit Risk Management or OCRM). In addition, after an initial and limited round of CDC audits several years ago, the agency revamped its CDC audit methodology and is currently in the process of implementing a second round of audits on a much larger portion of CDCs.

The past and continuing evolution of 504 loan oversight takes on a critical importance as a result of other major recent changes in the 504 program. Even before the loan oversight function began to implement the changes above, the 504 program underwent the major changes of:

> The implementation of statewide competition for all CDCs (504 lenders) throughout the country;
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> The relocation of SBA's 504 loan processing from the 70 District Offices to a Centralized Loan Processing Center in Sacramento, California;
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> A dramatic expansion of PCLP program use by a small percentage of CDCs typically located in the highly competitive urban markets of only a few states; and
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> The agency supporting the expansion of CDCs into any state contiguous to the CDC's home state, and the further expansion of

CDC territory into neighboring states under the auspices of ‘Local Economic Areas’.

These changes have had a dramatic effect on 504 program delivery in most states and markets throughout the country, and many of these changes have been highly positive.

For example, in the four year period between FY2003 and FY2007, the 504 program grew dramatically in terms of number of loans (55%), dollars of assistance provided (100%), assistance to rural areas (65%), assistance to women and minority owned companies (78%), and in terms of jobs created and retained (51%). In short these changes spurred a huge and unprecedented level of industry growth in lending in all sectors of 504 operation and in their economic development impacts.

The Importance of Optimal Oversight

This huge increase that 504 lending has experienced over the last several years has had extremely substantial positive effects to date, not only on the vast numbers of additional small businesses assisted, but also on the economies of their communities. While these results are significant and ongoing, they also magnify the importance and the potential danger of growing a program at such a rate, with oversight that is anything less than optimal. My purpose today is not to criticize or tear down what has been done by the Agency. Rather it is to suggest additional changes that I and our industry believe would substantially strengthen the effectiveness of the agency’s oversight program to insure the continuing growth 504 financing on small businesses and the substantial impacts on their communities.

Needed Improvements in Program Oversight

SBA 504 program oversight has evolved, but is still lacking in several important ways. Although the reviews do cover a myriad of credit and eligibility issues on a free standing basis, the most glaring omission is the failure to review or provide a finding on the adequacy of the overall structure of the funding.

For example, while the “504 File Review” checklist asks questions about ability to repay, management, capitalization, and collateral, no where on the form is there a question or place for a finding as to the overall reasonableness and/or adequacy of the overall structure of the project in view of all of the facets of the credit. To me this is analogous to analyzing all of the separate systems in a car, without asking or ever determining if the car actually runs.

The role of the 504 program is to provide growing small companies with credit in amounts and on terms that the private sector alone would not. To do this properly, <u>the underwriting and structuring of each financing must be done in a manner which balances the interests of the SBA with the needs of the small business concern and the community</u>. This is absolutely critical to performing the proper role of the CDC and to maintaining the impact, quality and the integrity of the 504 program.

This issue has major implications on the effectiveness of the current OCRM audit process. It is very positive that CDC reviews are now being actively done on a prioritized basis by competent OCRM representatives. However, failure to examine the whole causes the process to miss critical opportunities to bolster program quality.

<u>Gaps in PCLP Loan Oversight</u>

In the PCLP program, a rapidly growing portion of SBA's overall 504 portfolio, the lost opportunities for loan quality control are also substantial. In several of the most competitive markets of the country, and perhaps particularly in California, it is common knowledge that some PCLP lenders are:

1. Doing 504 loans that are not properly underwritten according to established SBA loan regulations and guidelines;
2. Routinely providing up to 100% financing without any reasonable basis of doing so, which is adverse to the Congressional intent for the 504 program; and
3. Have even been reported to SBA for financing projects that are not eligible according to SBA regulation and policy, specifically in the area of environmentally impaired projects.

Unfortunately, the effect of this is not limited to one or two CDCS and SBA's field audits have, to the best of my knowledge, either failed to address these situations, or happen too long after a loan is made to be useful in this process. When a CDC's zeal to compete in the marketplace results in violating SBA rules and policy, other CDCs are then forced to either meet the lower standards or lose project after project. In the absence of needed additional oversight, this produces a competitive tide that is lowering all of the boats of credit quality and program integrity in some of the most active markets in our industry.

The Sacramento Loan Processing Center

In attempting to deal with ever increasing 504 loan volume with very limited staff, the SBA Sacramento Loan Processing Center (SLPC) has devised a number of efficiency mechanisms that save staff time, while continuing to insure loan quality. For non-PCLP lenders with good track records and portfolio performance, SLPC allows a limited submission of documents in a loan submission, called the Abridged Submission Method, or ASM. In exchange, it is Sacramento's goal to audit 10% of the files submitted through ASM. They do this by requiring the CDC to ship a complete package for review on 48 hours notice. Any ASM-approved CDCs caught with incomplete or ineligible applicants are suspended from ASM.

The ASM audit process utilized by the SLPC needs to be adopted for PCLP loans. Broader utilization of this efficient and low cost program would send a very strong message to PCLP lenders, who would not want to risk their ability to participate in PCLP for a single loan. This action would filter down to all CDCs, so that loan making quality would improve, and the playing field of the marketplace would be made more level.

How Much Can Be Done With How Little?

As mentioned above, the SLPC has utilized many techniques to try to get the absolute most production out of the extremely limited number of processing loan staff. However, in the opinion of the industry, the combination of the extremely limited staff positions, the major constraints in compensating staff to incent retention, and the restrictions and red tape now in place in filling critical positions that have become vacant, has pushed the Center beyond the breaking point.

A result of this staff shortage that has the most detrimental implications on lender oversight is that, in order to try to maintain loan turn-around goals, the Center has been forced to put off doing ASM audits for a number of months now.

A second result is that even though loan approvals (authorizations) can be issued in as little as five days, it now takes approximately 2 weeks to get the changes and clearances for environmental and appraisal reviews needed to enable the project to be funded. So while the nominal goal of issuing a loan decision is met, the small business concern must still often wait weeks in order to obtain the other clearances needed to fund their loan.

NADCO commends the work of the Sacramento Loan Processing Center and their staff, but believes the Center needs to substantially expand its authorized staff (and rapidly fill open positions) to meet the rapidly growing increase in 504 loan packages submitted to it, as well as re-implement ASM reviews for non-PCLP CDCs. Clearly, more SBA staff would be required to expand ASM to include PCLP lenders as well.

The Value of Predictive Loan Scores

The Agency has been working to introduce systematic and modern technology to portfolio management, an example of which is the program provided under contract with Dunn & Bradstreet. We believe that while the intent of this program was good, the value of the data is in question. Our experience with the D&B program is that it has significant problems, including:

1. From what we understand, the core of the D&B model is based on credit scores of the applicant company and loan guarantors. While this information could potentially be useful, it is redundant with current underwriting work, in that CDCs already pull credit reports and scores of all borrowers and guarantors, and do a much more thorough and fact-based underwriting of the applicant small business concern.

2. Other than an overall score and an aggregate counting of high, medium and low risk loans in a CDC portfolio, the data is useless to a CDC as D&B considers the information “confidential”. D & B contractually restricts SBA OCRM from identifying to a CDC its borrowers that the model deems a high risk. This is a major weakness of this entire process, because it makes it impossible for a CDC to put the model results to practical use by working with potentially problem borrowers and using the information to modify their underwriting standards.

3. Even in aggregating a CDC’s loan portfolio results, the scores or predictions seem questionable. For example, in the case of our CDC, and according to SBA data, our currency rate including loan deferrals is currently over 99%. Our liquidation rate 0.5%, or one liquidation for every 200 loans over the life of the loans. We service a portfolio of almost 800 loans, and last year had no liquidations at all. The D&B model indicates that 2.1% of our portfolio is comprised of higher risk loans, and 14.5% are “moderate risk” Based on my discussions with a number of my

counterparts in the industry, such “disconnects” with actual portfolio history are typically even larger for many CDCs, with regard to the model output.

4. Even if this predictive model is right, the model formulation includes no input whatsoever about how the CDC structured the overall project so as to hedge perceived higher risk. So CDC actions, such as requiring higher down payments or additional project collateral, are not even factored into the D & B model.

   One of the greatest values the SBA 504 program brings to the marketplace is to make capital available that the private sector alone won’t do. CDCs often do this by balancing the extra risks in a particular financing by taking additional down payments, extra collateral, or other credit enhancements. This is the art of deal making in small business economic development, and these factors aren’t even taken into consideration in the model at all.

In summary, the D&B system is a model, which in finance parlance is nothing more than a projection. In the world of small business finance, we discount financial projection deals. There needs to be significantly more openness and disclosure identifying a CDC’s perceived weaker borrowers so that we can determine if the model is accurate. Only then can CDCs can put this information to productive use in working with higher risk borrowers and thus improving their portfolio performance and reducing potential defaults and loan losses for SBA.

<u>The Current Pending Legislation</u>

NADCO appreciates all of the hard work of the Committee that has gone into creating S.1256, the Small Business Capital Access bill. In short, we believe that this bill, and the recently introduced S.2288, is exactly the one-two punch that is needed in statute to address many oversight and operational issues of the 504 program that we have discussed today.

NADCO believes that S. 2288, introduced by Senators Snowe and Kerry, proposes a common sense approach to lender oversight by the SBA. The portfolio performance information that it requires SBA to collect and evaluate on a quarterly basis should be readily available to the agency. SBA’s evaluation of a CDC’s portfolio on a real time basis will provide a much better basis for evaluating and ranking CDC loan making performance than the current system employed by SBA. We are pleased to support this approach and look forward to working with the Committee on any fine tuning of it that may be required. We are also pleased to support the executive compensation section of the bill, which we believe will help CDC boards of directors have a better understanding of their fiduciary responsibilities in overseeing the operation of a non-profit CDC.

We urge the Committee to move S.1256, and S. 2288 forward, as these are both critical pieces of legislation that will establish the foundation and strengthen the framework for enhanced SBA oversight and CDC operation.

Proposed New Lender Oversight SBA Regulation

SBA has just issued for comment a comprehensive new Federal Regulation governing lender oversight that will significantly impact all CDCs. Our industry will need some time to provide the Committee and agency with complete comments. Our initial review indicates several problems.

This Regulation appears to make the risk rating system created by the D & B database the sole system for CDC reviews. Our industry has concerns about this approach, as previously outlined and would not likely endorse it as the sole process of evaluation.

SBA proposes to require compliance by all CDCs with the Single Audit Act and OMB Circular A-133. Our preliminary inquiries indicate that the effect of this rule, if adopted, would be staggering for many CDCs in our industry. Many CPA firms do not even offer A-133 audits, Our own CPA indicated that our audit costs would double or triple. This could cause a severe increase in costs for numerous small CDCs that could drive them out of the 504 loan program. Moreover, such increased costs would almost certainly reduce economic development delivered by our CDC industry in many areas of our country.

Additionally, SBA has included in the preamble of the proposed Regulation its CDC compliance cost estimates and audit cost estimates for changes required by our industry. SBA has also certified that there will be no significant impact on small entities, either CDCs or small businesses. We believe these estimates and the certification to be substantially in error.

The Impact Economic of the 504 Program

SBA programs have recently been criticized for failing to measure the full economic impacts of their loan programs. Because of our own concern about this, last year NADCO commissioned a study of 504’s economic impact by Applied Development Economics (California State University, Chico). This study is currently being completed. In a final draft report to NADCO's board, the report found that within 2 years of receiving 504 loans, seventy-seven percent (77%) of the businesses increased their revenues and sixty-two percent (62%) reported job growth. During the two year study period (2003-2005), the 504 program supported a direct net growth of 54,000 jobs, and the economic multiplier effect added another 66,000 jobs. The total increased business activity and employment also generated an increase in federal taxes and other revenue of $1.75 billion per year, and state and local taxes and revenues of an additional $2.2 billion. For the federal revenue alone, this represents a 23% return for every dollar of 504 loans. When including state and local revenues, the return on investment increases to <u>$94.00 per dollar of program cost</u>.

NADCO will be furnishing copies to all Members of the Committee within the next few weeks, as the report is finalized and published. We are gratified that our contention that the creation of SBA's 504 program by Congress, and it's implementation by the SBA and CDCs has been found to have major economic effects in communities throughout the country. It is clear that 504 is, in fact, one of the most cost effective expenditures made by the entire Federal government, and certainly the most efficient economic development loan guaranty program in the government.

<u>Summary</u>

In closing, I am here today representing NADCO and the CDC industry. Currently, there is neither a loan liquidation nor loan default crisis in our industry. I am offering these comments with the hope that the adoption of our suggested changes will further improve the loan oversight of our industry, and thereby improve loan making and 504 program performance in the future.

We hope that we can continue to work closely with your Committee and with the SBA to insure that our industry operates according to the best practices and highest standards. In doing so, we will continue to assist more and more companies in creating new jobs within their communities.

I thank Chairman Kerry, Ranking Member Snowe and Members of the Committee for your work on the Small Business Capital Access bill and your steadfast and tireless work for the good of America's small businesses and the economic development of their communities.