NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

"SBA Lender Oversight Hearing"

Testimony before the Senate Committee
On Small Business and Entrepreneurship

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NAGGL Gets It.

Mr. Chairman, Ranking Minority Member Snowe, and members of the Committee, my name is Tony Wilkinson. I am president and chief executive officer of the National Association of Government Guaranteed Lenders (NAGGL), a trade association of approximately 700 banks, credit unions, and non-depository lenders who participate in the Small Business Administration's 7(a) loan guarantee program. NAGGL members generate approximately 80% of the annual SBA 7(a) loan volume.

NAGGL is pleased today to testify on the Small Business Administration's lender oversight efforts. We recognize the benefit of quality lender oversight and support its implementation. Since the introduction of federal credit reform, our member institutions have witnessed the impact that portfolio performance has on subsidy rates and program fees. We are acutely aware that when individual lenders do not engage in appropriate loan underwriting, servicing and internal control practices, the results to the program can be detrimental in terms of the future cost to borrowers and lenders.

More specifically, history shows that the lending community is aware of the need to work with the SBA to police itself. For example, it was the 7(a) industry that raised concerns about the SBA's implementation and management of the LowDoc Program. Why? Since there were no written policies for quite some time after the LowDoc pilot program was implemented, the program invited participation by lenders that did not have sufficient interest in quality lending. In the 1990s, it was NAGGL that raised concerns to SBA and Congress about the practices of the industry's then largest lender. The evidence is clear: lenders and the industry do care about quality lending. Federal credit reform requires us to care because one bad lender can affect the ability of every other lender to lend; one bad lender can substantially increase the costs of other lenders and borrowers participating in the program. One bad lender can make it impossible for future borrowers to receive capital at the lowest possible cost. Therefore, it is in my members' individual and collective interests that SBA engages in a sustained, effective lender oversight program. That said, a quality lender oversight program cannot guarantee that it will detect or prevent fraudulent activities.

A quality lender oversight program should provide a cost effective, statistically valid means of detecting increased risk in the overall SBA portfolio as well as in individual lenders' portfolios. Initially, this is typically accomplished with a properly functioning offsite monitoring program. Upon detection of adverse trends, the oversight program should direct an onsite review of the institution's asset quality and lending practices to validate concerns, provide corrective actions, or issue enforcement directives. And, in the case of the 7(a) program, which has a public policy purpose, devising an appropriate oversight strategy must also include consideration of how well the public policy goals of the program are being met.

We do not believe the current offsite monitoring program being developed by the SBA will provide a cost effective, statistically valid method for detecting increased risk in the portfolio. The SBA has access to significant amounts of data relating to historical loan performance, delinquencies, and lender activity. However, it does not appear that this information is routinely utilized as part of an early warning risk assessment system. The SBA is relying upon a Dun and Bradstreet computer program that forecasts a percentage of loans in a lender's portfolio at high, moderate, and low risk of default. Unfortunately, the forecast criteria, as well as the specific loans identified as high risk are never shared with the lender. The lender is unable to determine whether it agrees with the analysis, and if it does agree, take appropriate action. In addition, the SBA is requiring the participating lenders to pay for this Dun and Bradstreet program through separate fees. Lenders were not provided the contract for review to determine the appropriateness of their individual fees, nor are they provided specific loan information to determine if they are receiving any value for their cost. Moreover, portfolio performance forecasts by the Dun and Bradstreet model are highly questionable. Below is a chart which we believe supports our position.

Column A shows the actual 7(a) repurchase rate for the previous 12 months. Column B shows the Dun and Bradstreet projected purchase rate for the next 12 months. Thus far, a consistent trend of projecting higher defaults than actually occur (similar to what was done for years in the 7(a) subsidy rate calculation) is evident. And there is a trend that shows a widening disparity: the actual repurchase rate is going down while the projected repurchase rate is going up. If one compares the 3/31/06 projected rate (2.4%) to the 3/31/07 actual rate (1.8%), and the 6/30/06 projected rate (2.3%) to the 6/30/07 actual rate (1.7%), the SBA and Dun and Bradstreet predicted approximately 25 percent higher defaults than actually occurred.

	A Actual Repurchase Rate Previous 12 Months	**B** D & B Projected Repurchase Rate Next 12 Months
06/30/2007	1.7% Actual	2.8% Projected
03/31/2007	1.8% Actual	2.8% Projected
12/31/2006	1.9% Actual	2.5% Projected
09/30/2006	1.9% Actual	2.4% Projected
06/30/2006	1.9% Actual	2.3% Projected
03/31/2006	1.9% Actual	2.4% Projected

NAGGL does not believe that the SBA can rely on these inaccurate projected repurchase rates. If that is the case, on top of apparent inability to accurately forecast them, why are participating lenders being forced to pay for the model in the first place? Why are some lenders being asked to pay in excess of $100,000 annually for lender oversight when they get no value from it?

The results of the ongoing offsite analysis should be supplemented with onsite reviews for any participating lenders deemed to be high risk. It is imperative that the onsite activity provides timely feedback and meaningful analysis to the participating banks and the SBA. It is also important that this oversight does not result in duplication of existing oversight activities from other regulatory agencies (and a duplication of the cost already associated with those activities). It is an established fact that the bank and credit union industries already have substantial lender oversight from the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Federal Reserve Board, and various state banking regulators. NAGGL believes that before initiating its own onsite lender oversight activities, the SBA should be required to demonstrate that it is adding value to current federal and state oversight efforts and not just duplicating existing efforts. It would appear reasonable for the SBA to work with the existing regulatory agencies to accomplish its onsite examination objectives. A partnership of this nature would ensure consistent application of examination procedures as well as regulatory experts to provide safety and soundness testing of SBA portfolios. We recognize that an inter-regulatory agency partnership will require the commitment and cooperation of several agencies; however, we believe that this type of arrangement is necessary to provide the most cost effective and meaningful determination of risk. We would hope that the SBA is willing to pursue this avenue prior to arbitrarily requiring that participating lenders bear the cost of additional regulatory examination.

An onsite review of a participating lender's SBA portfolio should focus on underwriting criteria, internal controls, and servicing practices. For example, when a regulatory agency performs a safety and soundness review, the examiner is trained to determine the risk associated with a specific loan based on various categories including a borrower's historical cash flow, capital adequacy, repayment history, debt levels, collateral coverage, and overall industry and economic trends. The examiner utilizes this information to assess the institution's overall risk as well as risk in individual loans. The examiner discusses the results with the lender and gives the institution an opportunity to respond to the issues raised. Under the current onsite review procedures of the SBA, these steps are not occurring. Instead, the SBA auditor focuses more attention on the completeness of the file as opposed to the quality of the asset.

While it is important to ensure that an SBA loan file has sufficient documentation to comply with various SBA regulations, this activity does not provide a reasonable level of lender oversight or an early detection of increased program risk resulting from the activities of an individual participant. It would appear reasonable to assume that documentation compliance is assessed during the repurchase process for an individual loan. SBA's guarantee is a *contingent* guarantee, which means that if a lender fails to fully meet its responsibilities, the SBA can—and does—reduce the amount of the guarantee payment to lenders. In the most egregious cases of imprudent lending, the SBA denies its liability under the guarantee. Therefore, the very nature of the guarantee relationship serves to assure that lenders comply with the various SBA regulations while engaging in quality lending. Also, the guarantee program is a sharing of risk and not a complete transfer of risk away from the 7(a) lending community. The lenders have an ongoing responsibility to their regulatory oversight group as well as to shareholders to ensure that safe and sound lending practices are maintained.

Mr. Chairman, before proceeding, let me digress a moment to clarify the distinction between credit underwriting and credit scoring. I think it will help illuminate the difference between a banking agency audit and an SBA onsite review. When a borrower asks for a loan, a lender gathers information on the borrower that ranges from information about whether the applicant is current on taxes and utility bills to what tax returns indicate about the applicant's ability to repay the loan. This point is critical: it is the credit underwriting—determining the borrower's ability to repay a loan—that protects a taxpayer. On the other hand, credit scoring looks at a borrower's performance on current obligations—certainly one ingredient in determining the ability to repay—but obviously not a singularly conclusive one. The banking agencies look over the lender's shoulders when they examine loan files to make sure the loan is creditworthy. This is not SBA's focus. Instead, their onsite review is principally a documentation review with less emphasis on the underwriting or loan servicing standards associated with a loan.

The SBA's current lender oversight efforts apply to the largest 350 lenders; however, SBA's own statistics say that it is inactive and active lenders with portfolios under $1 million that pose a significant risk to the 7(a) program. SBA's lender oversight system does nothing to address the problems associated with these lenders' portfolios. The SBA has recently announced a rural development initiative, similar to the LowDoc

Program, to induce even more smaller-volume lenders to participate in the program. NAGGL supports getting more small rural banks in the program; but at the same time, the SBA must assure that these lenders can perform the appropriate credit underwriting and servicing for loans made under this initiative.

Mr. Chairman, I would like to congratulate you and Senator Snowe on the introduction of S. 2288, a bill that would significantly improve SBA's lender oversight function without unduly increasing the regulatory burden on lenders. It directs the SBA to use information that is already available to identify on a real time basis those lenders whose portfolios are exhibiting a form of stress, to determine whether an onsite review is warranted due to such stress, and to work with the lender to address any portfolio problems. This is similar to other regulatory oversight programs conducted by the banking agencies. S. 2288 also requires the SBA to develop outcome criteria by which the effectiveness of the program can be measured. Again, this is an idea NAGGL has long supported. Therefore, we believe that S. 2288 is a major step forward in improving lender oversight.

Despite the need for adequate lender oversight, the performance of the SBA portfolio appears good. With respect to the misperception that 7(a) loans generally have an inordinately high default rate, it should be noted that according to the president's FY 2007 budget submission, the default rate on 7(a) loans made during FY 2007 was projected to be 6.96 percent over the entire 25-year life of the cohort, less an estimated 52% recovery rate, for a net loss rate of 3.34 percent. The annual net loss rate for loans at FDIC-insured banks is reported at 0.5 percent (June 20, 2007, *FDIC Quarterly Bank Profile*). While there appears to be a significant disparity between the loss rates, it should be noted that this is not an “apples to apples” comparison. The 7(a) loss rate represents the life of the lending pool (loan inception through payment in full or final charge-off) while the commercial loss rate is for one year. If one applies the banking method to SBA loss data, the annual net loss rate in the SBA 7(a) program would be in the 0.40 to 0.50 percent range, a loss rate that is comparable to the conventional lending loss rate.

Credit risk relating to specific small businesses is only one factor when predicting future defaults. The long-term business risk, economic risk and interest risk all contribute to the 7(a) default estimate, while the default rate for commercial banks is reduced as a result of the short-term nature of the loans. This further illustrates the need for performance standards that appropriately measure risk and provide a meaningful comparison to commercial bank and regulatory standards.

Finally Mr. Chairman, the SBA has just published a 35-page proposed rule on lender oversight. NAGGL will submit a formal letter of comment on the proposed rule at a later date. The primary focus of the regulations is to establish “Grounds for Enforcement Actions”, establish types of “Enforcement Actions” and describe “Enforcement Procedures”. It does not address issues of loan underwriting and servicing. The proposed rule does create capital requirements for non-federally regulated lenders and allows the SBA to take enforcement action against lenders that the agency determines—at times subjectively in the proposed rule—to be violating agency rules and procedures. This is only one piece of an effective lender oversight puzzle.

Mr. Chairman, I would be pleased to answer any questions.