Best Practices
of
Section 7(a) Lenders

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Inspection Report

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TO: Philip Lader
Administrator

THROUGH: James F. Hoobler
Inspector General

FROM: Tim Cross
Assistant Inspector General
for Inspection and Evaluation

SUBJECT: Inspection of Best Practices of Section 7(a) Lenders

We are pleased to submit our inspection report on the ***Best Practices of Section 7(a) Lenders***. It focuses on the credit management procedures identified by the nine successful lenders in our case studies as the most effective means for controlling risk. Although not all the procedures may be applicable to every 7(a) lender, we believe that by encouraging such practices, SBA will be able to improve the effectiveness of its lending partners while keeping loan losses to a minimum.

Specifically, the practices may be useful as a guide for lenders who are new to the program or who need to improve their credit controls. We also suggest that SBA take the practices into account when considering candidates for the Preferred Lenders Program (PLP) or conducting reviews of existing PLP lenders. Among other things, we found that the successful lenders in our sample:

> **Rely more on evaluating an individual borrower's situation than on automated screening methods such as credit scoring.** Although some of the lenders use automated credit scoring for consumer loans, eight of the nine avoid it for small business loans largely because they do not think there is a strong correlation between a borrower's past credit history, as measured by the score, and how a small business loan will perform. In most instances, the lenders use a more personal approach to evaluate businesses on a case-by-case basis.

Generally avoid using external loan packagers. Most of the lenders in our sample tend to avoid third-party loan packagers who prepare prospective borrowers' 7(a) loan applications for a fee. Although one lender noted that packagers have expedited its loan approval process, others stated that packagers often submitted substandard loans and/or insufficient documentation because, in part, they receive their fees regardless of the quality of the applications.

Require the borrower to pledge both personal and business assets as collateral, despite the availability of the SBA guarantee. The guarantee may be used by lenders to augment collateral, but none of the lenders in our sample appear to use it as a full substitute for collateral. Moreover, they all require pledges of personal assets, such as a borrower's residence or securities, if they deem it necessary.

Centralize final lending decisions to ensure consistency and control. Both large and small lenders require at least one official other than the originating loan officer to approve SBA loans. This helps standardize a lender's credit decisions.

Assign risk ratings to new loans and periodically reassess them through the life of the loans. In a risk rating system, a new loan is assigned a numerical value denoting its risk level; the number may be revised based on the borrower's payment record or other factors. This differs from credit scoring, which is usually used to screen applicants before issuing loans.

Proactively watch for warning signs of future loan repayment problems. Rather than waiting for loans to become past due, some lenders watch for indications of potential collection problems, like the borrower's failure to renew hazard insurance or decreased profits from the previous year's level.

Identify past due loans early and initiate vigorous collection efforts. Quick action at the first sign of delinquency can reduce the need for time-consuming collection actions and enable the lender to adjust the loan terms or resolve other problems at an early stage.

In his comments, the Associate Administrator for Financial Assistance (AA/FA) stated that some of the lenders' statements indeed described best practices in the industry. He expressed concern, however, over the findings on external loan packagers and on collateral. He noted that packagers serve a worthwhile purpose and that the practice of requiring borrowers to pledge personal and business assets whenever collateral is needed may not be the best practice in terms of carrying out Congress' and SBA's intent.

In response, the OIG inspectors noted that the lenders' comments applied to full-time packagers, rather than to any attorney or accountant who occasionally provides loan assistance to clients. We also pointed out the extent of loan packager fraud, as evidenced by recent criminal investigations on packager-prepared loan applications and SBA's formation of a committee in 1995 to examine the packager problem. On the issue of obtaining collateral, the OIG viewed this practice not as detrimental to carrying out the intent of the 7(a) program but, rather, as just one of many considerations required in making a loan. The AA/FA's comments and the OIG response appear in Appendices D and E, respectively.

Although our report contains no formal recommendations, we suggest that the Agency incorporate these best practices into its guidance for new lenders and its monitoring criteria for existing lenders. The OIG appreciates the excellent cooperation we received from SBA staff and from the lenders used as case studies and would be happy to discuss our findings with you at your convenience.

Attachment

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ABBREVIATIONS

CFO	Chief Financial Officer
CLP	Certified Lenders Program
CY	Calendar Year
EIS	Electronic Information System
FDIC	Federal Deposit Insurance Corporation
FY	Fiscal Year
LowDoc	Low Documentation Loan Program
OCC	Office of the Comptroller of the Currency
OFA	Office of Financial Assistance
OIG	Office of Inspector General
OIRM	Office of Information Resources Management
PLP	Preferred Lenders Program
SBA	Small Business Administration
SBLC	Small Business Lending Company

EXECUTIVE SUMMARY

Purpose and Background

Under Section 7(a) of the Small Business Act, the Small Business Administration (SBA) guarantees up to 90 percent of loans made by private lenders, i.e., banks and nonbank lenders such as Small Business Lending Companies (SBLCs), to small business borrowers who cannot obtain credit elsewhere on reasonable terms and conditions. In fulfillment of its guarantee to lenders, SBA currently purchases between $400 million and $450 million of defaulted 7(a) loans annually, with annual purchases projected by SBA to double by the year 1999 if loan demand forecasts are realized. **Although subsequent recoveries reduce the amount of actual losses, SBA officials anticipate that the dramatic increase in the number of 7(a) guaranteed loans combined with both recent and anticipated reductions in staffing could hamper the management of the portfolio. Accordingly, the Agency will need to rely even more heavily on its lenders to keep losses on loans to a minimum.** This inspection seeks to identify the best credit risk management practices of a cross-section of successful lenders for SBA management's consideration as guidance for 7(a) lenders.

The Office of Inspector General (OIG) initiated this study to help SBA management identify and encourage good program operations. The objective was to identify practices that could improve 7(a) lenders' credit risk management systems and, conversely, help SBA identify lenders likely to pose a higher risk of loan defaults. By recognizing the best practices of some of its more successful lenders, SBA can encourage or require that those same practices be adopted by lenders whom the Agency believes need to improve their management of SBA-guaranteed loans.

The 7(a) program has grown dramatically over the last few years, with approved 7(a) loans increasing from $5.9 billion in Fiscal Year (FY) 1992 to $7.7 billion in FY 1996, although the Agency had received appropriations for a $10.8 billion program for that year. An appropriations level of $7.7 billion has been approved for FY 1997. Even if the percentage of nonperforming loans SBA purchases from lenders remains constant or declines, the Agency may face significant dollar losses simply because of increases in the 7(a) program's size.

In addition, the number of SBA employees (excluding disaster assistance staff, most of whom are employed on a temporary basis) has decreased nearly 26 percent--from 4,120 in FY 1990 to 3,054 in FY 1996. The lending industry has also changed, with the number of commercial banks declining from 12,778 in 1990 to 10,515 in 1995. Thus, a resource-

constrained SBA must balance the seemingly conflicting goals of guaranteeing loans that lenders otherwise might not make with keeping purchases of defaulted loans to a minimum--all during a time of major lending industry change. A key to resolving this issue is to determine what practices SBA's lending partners could most effectively use to minimize losses, while serving the potentially higher risk borrowers that the 7(a) program was established to serve.

To identify best practices, we researched modern credit analysis and monitoring techniques and obtained relevant financial data from SBA and outside sources. With the assistance of SBA officials, we selected nine active and successful 7(a) lenders that varied by size, geographic location, small business lending focus, and type (bank or nonbank lender). We then visited each lender and reviewed the policies and procedures that they deemed essential for sound credit initiation, analysis, and monitoring.

For the purpose of this report, the term "best practices" refers to those credit management practices identified as the most effective for controlling risk. The term does not imply that the practices represent an exhaustive list of all effective practices. Because this study's conclusions are based on case studies of nine lenders, they cannot be projected to the universe of 7(a) lenders; the selected lenders are a cross-section (not a representative sample) of 7(a) lenders. We believe, however, that the best practices may prove to be a useful guide for those lenders who either need to develop procedures for the management of their SBA loan portfolio or wish to improve their controls over credit systems.

Findings

Based on case studies of nine successful lenders, selected with the assistance of SBA officials, the following practices have been identified as effective in controlling credit risk:

1. **Successful lenders foster a long-term and comprehensive relationship wit h their borrowers that extends beyond the scope of an SBA loan.** Most of the lenders we interviewed--banks and nonbank lenders alike--strive to establish lasting relationships with their customers and service all of their financial needs. As a result, lenders learn more about borrowers' financial status and profit from selling diverse services, while borrowers gain an enduring source of assistance as well as credit. Moreover, as lenders find their small business portfolios becoming more profitable, they become more likely to satisfy the SBA objective of providing more loans to those in the small business community who cannot obtain credit elsewhere on reasonable terms and conditions.

2. **Successful lenders rely more on evaluating an individual borrower's situation than on automated screening methods such as credit scoring.** Credit scoring, which uses computer models to measure and predict the creditworthiness of potential borrowers, is designed to improve the efficiency of the loan origination process. Although credit scoring traditionally has been limited primarily to consumer credit lenders who use it to approve credit cards or automobile loans, it is increasingly being used to evaluate small businesses. Some lenders use it to identify prospective borrowers at both ends of the spectrum: those who clearly qualify for a loan and those who clearly do not. Eight of the nine lenders we reviewed, however, avoid credit scoring for small business loans largely because they do not think there is a strong correlation between a borrower's past credit history, as measured by the score, and how a small business loan will perform. Although some of the lenders use credit scoring for consumer loans, they believe that lending to small businesses is simply too idiosyncratic to be analyzed effectively by an automated system. Moreover, lenders noted that credit scoring could preclude potentially good borrowers who did not have the "right" number of profitable years, the "minimum" number of years in a geographical area, or a way to quantify positive future prospects.

3. **Successful lenders generally avoid the use of external loan packagers.** Most of the lenders interviewed indicated that, with the exception of a few special situations, they avoid using third-party loan packagers, i.e., individuals or firms whose primary livelihood is preparing prospective borrowers' 7(a) loan applications for a fee. Although one lender noted that packagers have expedited its loan approval process, others stated that packagers often submitted substandard loans and/or insufficient documentation. In addition, the packagers were viewed as having insufficient incentive to bring in high-quality loans because they are paid regardless of the quality of the applications.

4. **Successful lenders require the borrower to demonstrate relevant experience in the type of business to which credit is to be extended.** The lenders look for technical experience and/or management background in the same industry. Seven of the nine lenders stressed the importance of a borrower having management experience in running a similar kind of business. This is especially important in an environment where the growth of small business is increasingly attributed to people being laid off by other companies.

5. **Successful lenders require the borrower to pledge both personal and business assets as collateral, despite the availability of the SBA guarantee.** Regardless of the type of small business loans (SBA or non-SBA), all the lenders contacted require borrowers to pledge personal and business assets whenever collateral is needed.

Although an SBA guarantee is sometimes used when the lender requires more collateral than the borrower can provide, none of the lenders we reviewed appear to use the SBA guarantee as a full substitute for collateral. Moreover, all lenders would, if they deemed it necessary, require personal assets such as the borrower's residence or securities. Some lenders hold collateral even if the equity has little value to provide a psychological incentive for a borrower to remain current on a loan.

6. **Successful lenders centralize final lending decisions to ensure consistency and control.** Although large and small lenders may differ in their methods of reviewing loans, both require at least one official, other than the originating loan officer, to review the SBA loan in detail and give final approval. This structure removes the final credit decision from dispersed loan officers and centralizes it in the hands of a single executive or team to ensure consistency, control, and efficiency in loan origination.

7. **Successful lenders hold the loan officers accountable for problems in the loans they originate.** Because a final credit review is only as good as the information passed forward and the analysis originally performed, the majority of lenders believe strongly in the accountability of the originating loan officer. Although none of the lenders emphasized punitive actions against the loan officer for a defaulted loan, in most cases the officer must assist in the collection of past due loans.

8. **Successful lenders emphasize quality loan origination over monitoring.** Eight of the nine lenders stated that proper loan origination is more important than monitoring. Most believe that shortcuts at the front end of the lending process will result in defaults. In addition, it may not be worthwhile to make risky loans given the amount of work involved in keeping such loans current.

9. **Successful lenders assign risk ratings to new loans and periodically reassess them through the life of the loans.** All lenders interviewed either already use a risk rating system or have plans to create one. In a typical system, a new loan is assigned a numerical value denoting its risk level at the time of origination. Over the life of the loan, the number may be revised depending on the borrower's payment record or other factors. Once deficiencies are identified, all the lenders have ways to highlight and track problem loans. Such risk rating systems differ from credit scoring, which is used before a decision to make a loan.

10. **Successful lenders proactively watch for warning signs of future loan repayment problems.** The best early warning system is simply to stay in touch with the borrower. Some lenders do not wait for loans to become past due; instead, they

watch for indications of potential future collection problems, like failure to renew hazard insurance or decreased profits from the previous year's level.

11. **Successful lenders identify past due l oans early and initiate vigorous collection efforts.** One of the most common attributes of the lenders in our sample, regardless of the type or size of the institution, is the aggressiveness with which they identify and seek to collect on past due SBA loans--usually within days of a payment being late. Such quick action can reduce the need for time-consuming collection actions and enable such lenders to adjust the loan terms or resolve other borrower problems early.

12. **Successful lenders emphasize working out a problem loan to avoid liquidation.** Several of the lenders we interviewed stressed that loan liquidation should be considered only as a last resort for recovering payment on a troubled loan. In general, they believe that greater recovery can be achieved through the continuation of loan payments from a going concern--even if the loan terms must be modified--than through the liquidation of assets.

Office of Financial Assistance Comments

The Associate Administrator for Financial Assistance (AA/FA) stated that some of the lenders' statements indeed described best practices in the industry. He also made a number of technical comments, many of which have been incorporated into the report.

Two best practices in particular concerned him. First, he took issue with the finding that the successful lenders sampled generally avoid the use of external loan packagers, noting that packagers serve a worthwhile purpose in meeting small business needs. He also challenged the finding that the lenders in the sample require borrowers to pledge personal and business assets whenever collateral is needed, noting that while collateral is important in the commercial market, the practice of requiring collateral may not be the best practice in terms of carrying out Congress' and SBA's intent.

In response to the AA/FA's concerns about loan packagers, the OIG noted that, as of October 1995, criminal investigations had been initiated on packager-prepared loan applications involving a potential loss to the Government of as much as $125 million. Moreover, SBA formed a committee in 1995 to examine the problem. With this as background, the OIG believes that lender misgivings about full-time packagers--as opposed to accountants and other professionals who may occasionally prepare loan applications as a service to their clients--cannot be ignored. On the issue of obtaining collateral, the OIG does

not view this practice as detrimental to carrying out the intent of the 7(a) program; it is instead just one of various considerations required in making a loan.

The AA/FA's comments appear in Appendix D. The OIG response to those comments appears in Appendix E.

BACKGROUND

Under Section 7(a) of the Small Business Act (Public Law 85-536, as amended), SBA guarantees private lenders' loans to small business borrowers who cannot obtain credit elsewhere on reasonable terms and conditions. SBA currently guarantees up to 90 percent of such loans. The guarantee amount is generally limited to $750,000 except for Defense Loan and Technical Assistance Program, International Trade, and Pollution Control loans. Emphasizing the use of guarantees against borrower default reflects the Agency's shift during the 1980s from directly subsidizing credit risk to improving access to capital at the least possible cost. More than 8,000 lenders--banks as well as nonbank lenders such as the Small Business Lending Companies (SBLCs)--have made at least one 7(a) loan in the past five years. SBA's share of outstanding 7(a) loans was approximately $21 billion at the end of FY 1996.

To manage its workload more efficiently, SBA allows some lenders greater authority to originate, monitor, and service 7(a) loans. Under the Certified Lenders Program (CLP), lenders are authorized to analyze borrowers' credit factors, but the loans must receive SBA approval before being guaranteed. Under the Preferred Lenders Program (PLP), lenders are authorized to analyze credit factors and make loan guarantees without prior SBA approval, although the Agency does review PLP loans for eligibility prior to issuing a loan number. There are currently over 900 participating CLP lenders and 350 participating PLP lenders, with PLP lenders responsible for 21 percent of the number of 7(a) loans approved and 39 percent of the dollar volume during FY 1996.

The challenge for SBA is to serve small business borrowers while minimizing the cost of the 7(a) program. Three factors make this an increasingly difficult task:

> First, the 7(a) program has grown dramatically over the last few years. From FY 1992 to FY 1996, the annual number of approved 7(a) loans increased from 24,284 to 45,845--with the total dollar amount rising from $5.9 billion to $7.7 billion, although the Agency had received appropriations for a $10.8 billion program for that year. An appropriations level of $7.7 billion has been approved for FY 1997. Even if the percentage of nonperforming loans SBA purchases from lenders in fulfillment of its guarantee remains constant or declines, the Agency may face significant dollar losses simply because of the 7(a) program's size. Although subsequent recoveries reduce the amount of actual losses, SBA currently purchases between $400 million and $450 million of defaulted loans annually. According to SBA's Office of the Chief Financial Officer (CFO), the Agency projects that annual purchases could double by the year 1999 if loan

demand forecasts are realized.

Second, the number of SBA employees (excluding disaster assistance staff, most of whom are employed on a temporary basis) has decreased nearly 26 percent--from 4,120 in FY 1990 to 3,054 in FY 1996. Although comparable data for the 7(a) program is not readily available, SBA officials anticipate that the dramatic increase in the number of 7(a) loans combined with both recent and anticipated reductions in staffing could hamper the management of the portfolio. Accordingly, the Agency will need to rely even more heavily on its lenders to keep losses on loans to a minimum.

Third, the lenders themselves have experienced major change. For example, from 1990 to 1995, the number of commercial banks declined from roughly 12,800 to approximately 10,500. Moreover, according to Agency officials, not only do lending institutions frequently change ownership, but they also experience high turnover in loan personnel. This volatility makes it difficult to determine whether the previous or current employees are responsible for a lender's performance--good or bad--on SBA loans. To complicate matters, even competent lenders can experience high SBA loan purchases because of regional recessions or other uncontrollable factors.

A resource-constrained SBA must, therefore, balance the seemingly conflicting goals of guaranteeing loans that lenders otherwise might not make with keeping purchases of defaulted loans to a minimum--all at a time when lenders are undergoing major change. A key to resolving this issue is to determine what practices SBA's lending partners could most effectively use to minimize losses, while serving the potentially higher risk borrowers that the 7(a) program was established to serve.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Office of Inspector General (OIG) initiated this "best practices" inspection in October 1995 out of concern that, with reductions in staff to monitor the 7(a) loan portfolio, SBA will be forced to rely more heavily on its lending partners to minimize defaults and fraud. The inspection's objective was to identify practices that could improve 7(a) lenders' credit risk management systems and, conversely, help SBA identify lenders likely to pose a higher risk of loan defaults. By recognizing the credit risk management practices of some of its more successful lenders, SBA can encourage or require that those same practices be adopted by lenders whom the Agency believes need to improve their management of SBA-guaranteed loans.

For the purpose of this report, the term "best practices" refers to those credit management practices identified as the most effective for controlling risk. The term does not imply that the practices represent an exhaustive list of all effective practices. Because this study's conclusions are based on case studies of nine lenders, they cannot be projected to the universe of 7(a) lenders; the selected lenders are not intended as a representative sample of 7(a) lenders. We believe, however, that the best practices of this cross-section of lenders may be a useful guide to the vast majority of lenders who either need to develop internal policies and procedures for the management of their SBA loan portfolio or wish to improve control over their credit systems.

To research modern credit analysis and monitoring techniques and to obtain relevant financial data, the inspection team used the resources of the Office of the Comptroller of the Currency (OCC), the Library of Congress, banking associations, bank data services, SBA/OIG, and the Department of the Treasury OIG. SBA regulations, standard operating procedures, CFO reports, and other SBA documents were reviewed. The team interviewed Federal Deposit Insurance Corporation (FDIC), Federal Reserve System, OCC, and lenders' officials, as well as officials from SBA's Office of Financial Assistance (OFA), CFO office, and district offices.

To select the lenders for our case studies, we reviewed SBA-generated data on 7(a) lenders and chose a sample from the universe of active lenders, i.e., from those who had originated at least 100 Section 7(a) loans during a ten-year period (FY 1986-95). SBA officials agreed this was an appropriate criterion for active lenders. SBA's Office of Information Resources Management (OIRM) then provided us with ten-year purchase rates and other data on active lenders from each region. SBA computes its purchase rates in terms of both numbers of loans and dollars, i.e., the number of loans purchased divided by the number of loans disbursed, and the dollar amount of loans purchased divided by the dollar amount of disbursed loans.

With the assistance of OFA, CFO, and district office officials, we identified criteria for selecting a cross-section of successful lenders. These included ten-year purchase rates at or significantly below both the mean and median rates we computed for a given region's SBA lenders (six of the nine lenders selected had the lowest or nearly the lowest purchase rates in their regions); unusual challenges, such as lending to an underserved high-risk market or correcting the deficient practices of prior management; portfolios of loans from five to ten years old to allow sufficient time for defaults to appear; geographic location and type of lender (bank versus SBLC); and asset size. To distinguish by size we used the informal banking industry standard of defining a small lender as one with less than $300 million in assets, a medium lender as one with assets between $300 million and $1 billion, and a large lender as one with more than $1 billion in assets.

The OIG inspection team also consulted with SBA staff in the relevant districts to ensure that the selected lenders were appropriate for the sample and then visited each of the nine lenders and reviewed the policies and procedures that they deemed essential for sound credit initiation, analysis, and monitoring. For a profile of the lenders selected, see Appendix B, Table 1.

This inspection was conducted between October 1995 and June 1996 in accordance with the Quality Standards for Inspection issued in March 1993 by the President's Council on Integrity and Efficiency.

FINDINGS

Practices of Successful 7(a) Lenders

This section presents the practices that were identified in our sample of successful lenders as key components for effective credit risk management in the handling of SBA loans. For a discussion of the common characteristics and concerns of these lenders, see Appendix A.

1. Successful lenders foster a long-term and comprehensive relationship wit h their borrowers that extends beyond the scope of an SBA loan.

Most of the lenders we reviewed strive to establish lasting relationships with their customers and service all of their financial needs--in contrast to some of their competitors, whom they view as too "transaction oriented." The emphasis on long-term customer relationships can be mutually beneficial for both lenders and borrowers: lenders learn more about borrowers' financial status and profit from selling diverse services, and borrowers gain an enduring source of assistance as well as credit. Moreover, as lenders meet the needs of small business borrowers for a wide range of services and find their small business portfolios becoming more profitable, the lenders become more likely to satisfy the SBA's objective of providing more loans to those in the small business community who cannot obtain credit elsewhere on reasonable terms and conditions.

When a lender markets services such as deposit accounts and lines of credit to an SBA borrower, the lender can gain the ability to monitor the borrower's overall financial condition and determine the borrower's ability to pay. One lender said that if a deposit account is having problems, the loan officer is notified because a low checking account balance can serve as a useful indicator. On the one hand, the borrower's business may be prospering, but funds may be low because the business requires the purchase of more inventory or material; consequently, the loan officer may be willing to provide the borrower with another loan. On the other hand, the borrower may have bid poorly on some potential contracts or simply may not be getting enough work. The loan officer can then try to arrange for management, technical, or marketing assistance. Moreover, if a problem occurs with an SBA loan, both personal and business accounts can be checked to determine why the borrower is late with a payment. For example, when a borrower becomes past due on a loan, the lender can monitor the business' checking account to see if any deposits have been made or if any abnormal account activity has occurred.

For some of the smaller banks with fewer branch offices, requiring borrowers to maintain checking and other accounts is not always feasible. These lenders prefer that their

borrowers have other service relationships, but it is not a requirement for obtaining a loan. Small Business Lending Companies (SBLCs) also can have a difficult time offering an expanded banking relationship with borrowers due to their limited locations and absence of deposit accounts.

Nonetheless, the two SBLCs we interviewed make an effort to establish long-term relationships and offer their customers as many services as possible. One pointed out that if it can help its borrowers reduce their costs, the borrowers will be more profitable and more likely not only to make their monthly payments, but also to grow and require other loans and services. The assistance includes value-added services such as discounts on shipping and long distance calling, as well as help in establishing employee benefit packages.

2. Successful lenders rely more on evaluating an individual borrower's situation than on automated screening methods such as credit scoring.

Credit scoring, which uses computer models to measure and predict the "creditworthiness" of potential borrowers, is designed to improve the efficiency of the loan origination process. It tests for variables such as a borrower's severity and frequency of delinquencies, number of creditors, average outstanding debt balances, and types of credit in use, e.g., bank cards or installment loans. Although credit scoring traditionally has been limited to consumer credit lenders who use it to approve credit cards or automobile loans, it is increasingly being used to evaluate small businesses. Some lenders use it to identify prospective borrowers at both ends of the spectrum: those who clearly qualify for a loan and those who clearly do not. Moreover, SBA is currently testing credit scoring in the "LowDoc" (low documentation) loan program, while requiring lenders to perform a full analysis as well.

Some of the lenders interviewed, as well as SBA's Office of Advocacy, believe that credit scoring is a "wave of the future," and that banking regulators may eventually require banks to credit score business loans. The banking regulators we interviewed concurred that credit scoring is an important evaluation tool being used by many of the larger banks. The theory is that credit scoring speeds up the loan approval process while minimizing underwriting costs.

Eight of the nine lenders we reviewed, however, avoid credit scoring for small business loans largely because they do not think there is a strong correlation between a borrower's past credit history, as measured by the score, and how a small business loan will perform. Although some of the lenders use credit scoring for consumer loans, they believe that lending to small businesses is simply too idiosyncratic to be analyzed effectively by an

automated system. The lenders prefer a more personal approach and indicated that because small business loans are less homogeneous than consumer loans, they need to be evaluated on a case-by-case basis. Even the one lender interviewed that was enthusiastic about the scoring process uses it only for small business loans under $100,000. Another lender noted that credit scoring may not be effective for evaluating borrowers other than the obvious ones scoring in the top and bottom 20 percent.

In addition to the usual credit analyses, some lenders evaluate intangible qualities of borrowers such as their attitudes, personal characteristics, and workplace operations. For example, one executive cited situations in which the transfer of a business' ownership and the related transition to new management posed substantial risk to the business' operations. Another area to assess, particularly with small entrepreneurs, is whether they will be able to adjust to changes in the company and be willing to hire employees that are strong in the areas in which they are weak. A common practice is to visit the borrower's establishment before underwriting a loan to get a better sense of the business or to check on a borrower's veracity. The successful lenders made it clear that lending is as much an art as a science, and that they have learned to follow their instincts when making loan decisions.

Despite a great deal of positive media attention about credit scoring taking the human factor out of lending decisions, some experienced lenders point out that credit scoring could hurt potentially good borrowers by not taking into account important personal factors such as character, standing in the community, or management experience. Moreover, lenders noted that credit scoring could preclude potentially good borrowers who did not have the "right" number of profitable years, the "minimum" number of years in a geographical area, or a way to quantify positive future prospects.

3. Successful lenders generally avoid the use of external loan packagers.

Most of the lenders interviewed indicated that, with the exception of a few special situations, they avoid using third-party loan packagers, i.e., individuals or firms whose primary livelihood is preparing prospective borrowers' 7(a) loan applications for a fee. Although one lender noted that packagers have expedited its loan approval process, others stated that the packagers they have dealt with tend to submit substandard loans and/or insufficient documentation. In addition, the packagers were viewed as having insufficient incentive to bring in high-quality loans because they are paid regardless of the quality of the applications. The interests of the packager and the lender may also be in conflict: if the packager has negative information about a borrower, for example, the packager has no incentive to report it to the lender. In contrast to the views expressed above, SBA's Associate Administrator for Financial Assistance (AA/FA) believes that packagers serve a worthwhile purpose in meeting small business needs and that the quality of any assistance

provided must be monitored not only by the Agency but also by the lending industry to make certain that the small business community receives quality service.

Nonetheless, most lenders in our sample were particularly distrustful of the accuracy of packagers' data. Reasons ranged from a concern that packagers lack proprietary responsibility for accuracy to experiences with packagers submitting insufficient information. An SBA district office concurred, stating that when a loan packager's name is on the documentation, the loan is somewhat suspect because the district office has found that such loans are unlikely to meet SBA financial standards. For example, one loan packager showed the prospective borrower as having a negative net worth. Moreover, the district office asserted that a packager is paid for completing loan applications--without regard to whether applications are approved. Again, there is little incentive for packagers to screen applicants carefully.

Other lenders avoid external loan packagers because they find it useful to have the borrowers prepare loan application information themselves. This procedure enables the borrowers to better understand their own businesses and to show greater commitment to the loan by developing a business plan and loan application themselves. This approach also provides the loan officer with better insights into the character and competence of the applicant. One lender even has the borrower, rather than an accountant, prepare the company's financial projections so that the borrower understands and is responsible for the numbers. On the other hand, two banks stated their willingness to serve as internal loan packagers for their borrowers to help them complete loan applications and pull together information for the complete package. They view this assistance as a reasonable service to provide potential customers and as a way to understand the customers' businesses better.

4. Successful lenders require the borrow er to demonstrate relevant experience in the type of business to which credit is to be extended.

Lenders look for both technical experience and management background in the same industry. One stated that it is not enough for a borrower opening a restaurant to have worked as a night manager; he or she must have had experience in making key business decisions. SBA district officials concurred that most business failures result from a lack of relevant management experience.

Seven of the nine lenders stressed the importance of a borrower having management experience in running a similar kind of business. In an environment where the growth of small business is increasingly attributed to people who are laid off by other companies, it is important that these entrepreneurs have the skills and management experience necessary to start a business. Moreover, seven of the nine lenders consider a borrower's past

experience in that line of business to be one of the most important considerations in originating a start-up loan. In some cases, lenders will approve a borrower for a LowDoc loan with little cash investment if the borrower has hands-on experience. Other lenders that are reluctant to loan to "start-ups" may choose not to classify a new business as a "start-up" if the owner has significant past experience in that type of business.

5. Successful lenders require the borrower to pledge both personal and business assets as collateral, despite the availability of the SBA guarantee.

Regardless of the type of small business loans (SBA or non-SBA), all the lenders contacted require borrowers to pledge personal and business assets whenever collateral is needed. Although an SBA guarantee is sometimes used when the lender requires more collateral than the borrower can provide, none of the lenders we reviewed appear to use the SBA guarantee as a full substitute for collateral.

Holding collateral can lower a lender's purchase rate. One small lender had approved several loans to borrowers whose businesses later failed, but the lender held enough collateral to pay off the defaulted loans.

Regardless of the amount of equity injection they require for a loan, lenders stated that they try to obtain as much collateral as possible on SBA loans, with coverage reaching as high as 70 to 100 percent of loan value. Moreover, all lenders would, if they deemed it necessary, require personal assets such as the borrower's residence or securities. Loans to "start-up firms" were even more stringent, with borrowers sometimes drawing on friends and family for collateral.

Interestingly, there was disagreement among SBA district officials on the importance of collateral. For example, at one district office, the belief was that just the threat of being able to take property improves the chances of collecting on a loan to such an extent that the lender or SBA may never need to carry out the threat. At another district office, it was suggested that the lenders should be more concerned about cash flow than collateral. To clarify its policy, SBA is drafting a standard operating procedure that will focus loan officer attention on a borrower's cash flow and character as the major considerations in loan origination. A lender agreed that requiring collateral is a difficult issue, especially when borrowers are reluctant to risk personal assets when they are already risking business assets to obtain a loan. Nonetheless, if a borrower does not have the collateral, this lender will look to the borrower's friends or family.

Some lenders hold collateral even if the equity has little value. The idea is to provide more of a psychological, as opposed to a financial, incentive for the borrower to remain current

on the loan. One loan officer said that although most of his borrowers do not have enough assets to cover the value of their loans, he still requires some type of collateral to get their attention.

Requiring personal assets can also dissuade a borrower from starting an excessively risky business in the first place. One lender told us that sometimes when an applicant is advised that personal collateral will be needed, the applicant will decide not to start the business, admitting to countless doubts about the business's viability.

6. Successful lenders centralize final lending decisions to ensure consistency and control.

Although large and small lenders may differ in their methods of reviewing loans, we found that both require at least one official other than the originating loan officer to review the SBA guaranteed loan in detail and give final approval. This structure removes the final credit decision from numerous loan officers and centralizes it in the hands of a single executive or team to ensure consistency, control, and efficiency in loan origination. A study prepared for SBA's Office of Advocacy indicates that centralizing and standardizing credit decisions is becoming increasingly common among large banks. The study also found that such a process expedites loan approval for customers, a necessity for many small businesses.[1]

In most of the smaller banks visited, the branches are required to send loan packages to the central office to be approved by senior management. The dollar amount of the loan often determines the level of seniority needed to approve the loan. For example, one lender requires the senior vice president to approve all amounts up to $75,000, an officer loan committee (five bank officers including the president) to approve loans from $75,000 to $350,000, and the director's loan committee (four directors and the president of the bank) to approve loans over this amount. In most of the small banks, the president is involved in all loan decisions; they centralize loan decision-making primarily because the size constraints of the institution make it practical to do so. One small bank attributed its low purchase rates to senior management's participation in the origination process.

In the larger banks and SBLCs, the loan officers tend to have a smaller role in the analysis process, i.e., they are primarily responsible for bringing in business and collecting supporting documentation. The loan package is then sent to a central location where it is

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[1] Laub, P. Michael and State and Federal Associates, Inc. Small Businesses and Large Banks, 1994, p. 70.

analyzed in the credit department, often by teams that specialize in different geographical regions. The final decisions are made by the credit department managers, with high value loans generally approved by senior managers.

7. Successful lenders hold the loan officers accountable for problems in the loans they originate.

Although many lenders have centralized the process for making final credit decisions, the loan officer responsible for originating a loan is still the primary source of information on the borrower. Because a final credit review is only as good as the information passed forward and the analysis originally performed, the majority of lenders believe strongly in the accountability of the originating loan officer. Although none of the lenders emphasized punitive actions against the loan officer for a defaulted loan, in most cases the officer must assist in the collection of past due loans. Even lenders with loan collection specialists insist that loan officers be part of the collection process. As one senior official commented, if an officer makes a loan, the officer collects on the loan. Keeping the monitoring and servicing function close to the loan officer may also keep a problem borrower from misrepresenting the facts of the loan transaction to the lender's servicing personnel.

A post-mortem review of "lessons learned," whenever a loan goes into default, has also proved useful. The loan originator and the lender's credit department meet to discuss the analysis involved in approving the loan and the reason the loan went bad. The purpose is to help the originator target key factors that should be addressed when evaluating future loans.

8. Successful lenders emphasize quality loan origination over monitoring.

Eight of the nine lenders stated that proper loan origination is <u>more</u> important than monitoring. In other words, they stress prevention over cure. Most of the lenders believe that shortcuts at the front end of the lending process will haunt them later. Besides, according to an SBA district official, it is not worthwhile for lenders to make risky loans because keeping them current requires too much work.

Proper loan origination requires a thorough understanding of the potential borrower. The basic lending factors to consider are the "five C's"--capital, capacity, collateral, cash flow, and character. Specific management and financial information sought by lenders includes the business plan, sources of repayment funds, level of leverage, company liens, and the business officers' and firm's credit histories. The lenders also seek face-to-face contact with the loan applicant, references from suppliers, and intangible judgments of the owner's

capabilities, e.g., perceptions regarding an owner's flexibility in handling problems or ability to compensate for personal weaknesses.

Obviously, loan officers can make mistakes during loan origination, including accepting a borrower's overly-optimistic projections and focusing on past profits rather than current debt. Loan officers sometimes fail to double-check financial statements or talk to a borrower's suppliers and customers. Finally, the officers may ignore a borrower's cash flow, capital, collateral, and lien position.

Nonetheless, even proper loan origination does not mean that lenders should reduce monitoring efforts once a loan is made. According to one lending officer, regardless of how careful lenders are in the origination process, they still need to engage in periodic monitoring to minimize defaults. For example, a borrower may look perfect on paper, but an uncontrollable event such as protracted street repair near the business could reduce sales volume and make loan repayment difficult. In such a case, early detection of trouble through monitoring and remedial actions such as rewriting the terms of the loan are the most effective ways to prevent a default.

9. Successful lenders assign risk ratings to new loans and periodically reasses s them through the life of the loans.

All lenders interviewed--banks and SBLCs alike--either already use a risk rating system or have plans to create one. In a typical system, a new loan is assigned a numerical value denoting its risk level at the time of origination. Over the life of the loan, the number may be revised depending on the borrower's payment record or other factors. Such risk rating systems differ from credit scoring, which is used before a decision to make a loan.

The systems used by most lenders in our sample were patterned after those developed by the FDIC or OCC. Lenders have considerable flexibility in setting up such systems; for example, the FDIC does not mandate that banks use a specific risk rating system but merely requires that a bank report to the FDIC what system it uses.

In one risk rating system reviewed, the lender assigns to a new borrower a rating of one (for a low risk borrower) through eight. The borrower is then monitored throughout the life of the loan. A borrower whose rating falls to four at any time is put into a special watch program wherein the bank tracks financial statements quarterly and visits with the company annually. According to a bank official, this program provides an effective early detection system, allowing bank officials to provide corrective action to the borrower such as restructuring a loan, renegotiating suppliers' contracts, creating a marketing plan, or even providing the borrower with more money to help the business succeed. The bank notifies

SBA only when the loan moves downward to a five or six rating or into liquidation.

Lenders identified various situations that can move a risk rating down. For example, a borrower may experience losses, profits below projections, litigation, a deterioration in collateral value, declining net worth, or bankruptcy. The borrower may also default on loan payments, violate financial covenants, or stretch out payments to suppliers. A reversal of these situations can also move a risk rating upward.

Lenders differ as to how actively they pursue information that might change a loan's risk rating. In some cases the rating seldom changes, while in others, lenders periodically review the ratings. For example, one lender reviews the loan's rating whenever it receives information that could affect the rating. If a loan's rating drops, the loan officer is notified and he/she contacts the borrower to identify the problem and to arrange for payment. In some cases, the rating may also change as a result of an annual audit or quarterly reviews conducted by the loan review department.

The inspection team found that the lenders without a risk rating system are interested in creating one. One lender plans to create a more detailed "one through ten" system because the lender has a relatively high risk loan portfolio.

Notwithstanding the character of their loan portfolios, all the lenders have ways to highlight and track problem loans once deficiencies are identified. Some lenders automatically place a loan on a watch list when the loan drops to a certain risk rating level. Others merely inform the loan officer that a loan has dropped in its rating so that the officer can contact the borrower. Still another lender handles the same situation by referring the loan to a specialized "problem asset committee" of senior officials.

10. Successful lenders proactively watch for warning signs of future loa n repayment problems.

According to SBA district officials, the best early warning system a lender can have is simply to stay in touch with the borrower. Some lenders do not wait for loans to become past due. Nearly half stated that they watch for indications of potential future collection problems. These include obtaining clues about a borrower's financial health through non-loan relationships such as a checking account or a line of credit, performing financial statement reviews on all loans, and informing the collection department of anything unusual. For example, while a borrower may be current on payments, he or she may have failed to renew hazard insurance or profits may have decreased from the previous year's level. Other indications of potential borrower problems include a sudden or dramatic change in profit margin, falling sales, failure to submit financial statements, or increased

absence from the business.

11. Successful lenders identify past due l oans early and initiate vigorous collection efforts.

SBA district officials suggest that lenders invite trouble when they ignore borrowers' early past due situations. One of the most common attributes of the lenders in our sample, regardless of the type or size of the institution, is the aggressiveness with which they identify problems and seek to collect on past due SBA loans.

One lender goes so far as to issue a delinquency report for borrowers that are just one day late and then has centralized groups make calls to those borrowers. Another lender flags loans that are only three days past due. A third lender has a loan officer call the borrower if the loan is five days past due; at ten days past due, the officer must report the loan to a credit review committee, thus ensuring the responsible loan officer's prompt action. Most lenders contact the borrower before the loan is 15 days past due.

The motivation for being so aggressive varies by lender. Some believe that quick action at the first sign of trouble lets the customer know that the lender is watching the loan's performance. It also reduces the need for time-consuming collection actions. Moreover, the lender can see if the borrower needs the loan terms adjusted or if other problems can be resolved early. Other lenders may depend on vigorous collection efforts, particularly if they serve high-risk borrowers. In such cases, little collateral may be available for liquidation anyway. One lender in our sample even sends someone to visit such borrowers each month to make certain the payments remain current.

Large loans are not always viewed as the ones most likely to falter. A major lender noted that small loans in default tend to deteriorate faster because there is less collateral to rely on.

12. Successful lenders emphasize working out a problem loan to avoid liquidation.

Several of the lenders we interviewed stressed that loan liquidation should only be considered as a last resort for recovering payment on a troubled loan. In general, the lenders conclude that greater recovery can sometimes be achieved through the continuation of loan payments from a going concern--even if the loan terms must be modified--than through the liquidation of assets.

Three of the lenders we interviewed stressed that they will do whatever they reasonably can

to avoid a loan liquidation. One lender stated that even if a loan is 180 days past due, the lender will often try to work out a problem loan rather than have SBA purchase it. The lender's emphasis on familiarity with the borrower and his/her business often enables the lender to avoid liquidation by developing tailored solutions to loan problems before liquidation becomes necessary. A second lender indicated that if the borrower previously had a good payment history, chances are that the borrower is worth the lender's investment in the development of a workout strategy. Such workout strategies may include extending loan maturity or modifying payment schedules. A third lender said that careful analysis of a loan at the time of origination provides important data that can be used to closely monitor loans, especially when a borrower shows any sign of problem. If a borrower does show signs of problems, such as late payments, the lender reacts quickly to find ways of avoiding liquidation. A rule of thumb, according to one SBA district official, is that if a lender can get three payments out of the borrower after a default, then the loan has a high probability of recovering.

APPENDIX A

COMMON CHARACTERISTICS AND CONCERNS OF SBA LENDERS

Despite myriad differences among the nine lenders we reviewed (see Appendix B, Table 1), there were several key characteristics shared by our sample relating to SBA and its role in small business lending. The inspection team did not attempt to measure or evaluate these shared characteristics against each other and cannot state whether one carries more weight in promoting good lending practices than any other.

High priority given to SBA lending. The lenders shared a strong belief that SBA and its products were extremely important to their institutions and to the small business communities they serve. In fact, six of the lenders noted that they consider their SBA lending operations just as important as their conventional lending operations. One bank indicated that it puts its best people in the SBA loan department. Another said it would not hire a loan officer who did not have a solid understanding of SBA lending processes and procedures. Such views are consistent with SBA district officials' views that the best lenders have teams dedicated solely to SBA loans, while lenders whose branch loan officers do not understand the 7(a) program are more likely to experience problems over the life of the loans.

In general, the lenders interviewed demonstrated a commitment to support SBA and its lending programs. All voiced their desire to promote and protect the integrity of SBA loan programs, and six stressed their philosophy of not using the SBA guarantee program to "make bad loans good" or to serve as the lending program of last resort.

SBA loans fit well in lenders' product lines. Several lenders described how many of the small business loans they originated would not have been made without an SBA guarantee. A majority (seven out of nine) in our sample emphasized the importance of SBA in providing longer term loans than could be provided through traditional lending methods. They stressed that this feature is especially valuable to a borrower who cannot demonstrate adequate cash flow to support repayment under a shorter term scenario. Increasing the term of the loan lowers the monthly cash outflow from a business; it also increases debt service capability and reduces the risk for the lender.

Lender suggestions. Several lenders suggested incentives and disincentives that SBA should consider as a means of defining and strengthening the Agency's role in small business lending. Their suggestions included the establishment of clear, concise, and consistent rules that reward lenders who maintain low purchase rates and penalize those

who cost the Government money. For example, several lenders recommended that SBA risk-rate lenders according to their purchase rates, basing guarantees on a lender's purchase rate: the higher the purchase rate, the lower the guarantee. Another suggestion was that SBA decrease its role in the processing of loans and increase its role as a regulator. Given the recent downsizing of SBA's personnel, shifting more responsibilities to the Agency's resource partners--especially its PLP lenders--may prove to be a viable alternative. The lenders encouraged a greater emphasis on SBA's regulatory function, i.e., monitoring loans and exercising its authority to deny a guarantee for loans prepared, serviced, or liquidated improperly. Several of the lenders took the idea one step further and suggested that SBA revoke agreements with lenders having relatively high purchase rates. SBA district officials tended to agree but cautioned against punishing a lender for problems beyond its control, such as a deteriorating local economy, or for taking on riskier loans to meet SBA's mission of providing access to capital for those who cannot obtain credit elsewhere.

Because PLP status is jealously guarded by many lenders, it was also suggested that SBA remove PLP status from those lenders with poor underwriting practices or, as an alternative, simply not honor the guarantee if a PLP lender uses poor judgment or fails to fulfill essential SBA documentation requirements.

Lender concerns. There were also two common concerns voiced by the lenders that may warrant attention from SBA. First, the lenders with large territories are now required by SBA to deal with two or more district offices, which may inadvertently issue conflicting guidance. Lenders suggested that SBA develop more consistent practices across districts and assign each lender to one specific district office regardless of where its loans are originated. Several current SBA initiatives like the continued development of the PLP Processing Center in Sacramento, CA; upgrading the loan servicing centers in Little Rock, AR, and Fresno, CA; finalizing new standard operating procedures (SOPs), and the performance of PLP lender reviews may alleviate such concerns by improving consistency in guidance and procedures across the board. Moreover, SBA officials stated that, in recent training of SBA field staff and lenders, the Agency stressed the need for uniform adherence to regulations and SOP requirements to ensure national consistency in program implementation. (See Appendix C for a list of 7(a) program initiatives.)

Second, the lenders voiced concern about the accuracy and completeness of SBA data. This is an area that also troubled district officials and the inspection team, particularly with regard to basic information such as lender identification numbers, number of loans made, and asset size of lender. Although it is too early to evaluate the effect, SBA is attempting to improve computer-based data reporting systems through OIRM. (See Appendix C)

APPENDIX B

TABLE 1
PROFILE OF LENDERS SELECTED FOR REVIEW

	LENDER A	LENDER B	LENDER C	LENDER D	LENDER E	LENDER F	LENDER G	LENDER H	LENDER I
Lender Asset Size (dollars in millions)	145	141	3,500[1]	2,400[2]	17,200	1,792	165	80	570
Lender Size[3]	Small	Small	Large	Large	Large	Large	Small	Small	Medium
1995 Small Business Lending Volume	Originated $17 million in SBA loans in FY 1995.	Originated $88 million in small business loans during CY 1995 -- $35 million was SBA related.	Originated 165 SBA loans in CY 1995 -- worth $40 million.	Currently holds 2,500 SBA loans in its portfolio. CY 1996 goal is to originate $250 million -- ½ consisting of Section 504 loans.	Originated 193 SBA loans worth $23 million in CY 1995. Set goal of 200 SBA loans for all of CY 1996.	In CY 1995 originated 1,461 SBA loans The dollar value of these loans was not available.	Currently holds about $16 million of SBA loans in its portfolio. CY 1995 total loans made and dollar amount of loans originated not available.	Currently holds about $15 million of SBA loans in its portfolio. CY 1995 total loans made and dollar amount of loans originated not available.	Currently holds about $25 million of SBA loans in its portfolio. CY 1995 total loans made and dollar amount of loans originated not available.
Market Served	Mid Atlantic	New England	New England	National	Pacific Northwest	National	Pacific Northwest	Midwest	Midwest
SBA Lending Focus[4]	Start-ups and firms with tight cash flow	Existing manufacturing firms with annual revenues of $2 million to $10 million	Existing firms but will consider start-ups	Primarily existing manufacturing and technology firms Approximately 25% of loans made are for start-ups	Small businesses with weak secondary support	Professionals (not many start-ups)	Targets the whole spectrum of borrowers	Companies too small for large lenders to target: mostly service industry and manufacturing loans -- start-ups consist of 20% of loans made	Venture capital oriented inner city loans
Type of Lender	Bank	Bank	Bank	Nonbank	Bank	Nonbank	Bank	Bank	Bank
Status (PLP, CLP, Regular)[5,6]	PLP	PLP	PLP	PLP	PLP	PLP	PLP	PLP	PLP

1. Represents the total assets for the holding company. The bank's total assets are not broken out separately
2. Represents total assets for the corporation as a whole -- including the small business financing operation
3. For purposes of this analysis, asset size of $0 -$300 million is classified as small, $301 million to $1 billion is classified as medium, over $1 billion is classified as large.
4. As described to SBA/OIG by the lender
5. PLP status does not mean that all SBA-guaranteed loans originated by the lender are PLP loans.
6. Lenders C and D received their PLP status after the SBA/OIG interview.

APPENDIX C

SBA'S ONGOING 7(a) INITIATIVES

At the time of the OIG's inspection (October 1995 through June 1996), SBA had a number of initiatives underway designed to increase the efficiency and effectiveness of loan origination, servicing, and liquidation. These initiatives included

- -- development of systems to facilitate centralized Low Doc loan processing;
- -- development and implementation of Low Doc liquidation regulations;
- -- improvement in capacity and efficiency in loan servicing capabilities at the Little Rock, Arkansas, and Fresno, California, Loan Servicing Centers;
- -- continued development of the PLP Loan Processing Center in Sacramento, California;
- -- improvement of monitoring systems using information developed at the PLP Servicing Center;
- -- continued commitment to the development of ways to increase the use of the Preferred Lenders Program;
- -- review, revision, consolidation and reduction of Standard Operating Procedures for the Office of Financial Assistance;
- -- evaluation of effectiveness of SBA and lender loan liquidation activities based on timeliness and recovery (Liquidation Task Force);
- -- development of electronic loan application processes for FA$TRAK, PLP and Low Doc loan programs;
- -- development of improved computer-based data reporting systems through the Electronic Information System (EIS);

-- development of improved access to loan program information through use of the Internet; and

-- performance of PLP lender reviews.

It was not within the scope of our review to assess these initiatives. Nonetheless, they appear to complement the efforts of private lenders by implementing procedures that focus on efficiency in the loan delivery, review, and liquidation process. By encouraging lenders to utilize the practices outlined in this inspection report, SBA can further advance the effective use of its resources.

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

OFFICE OF THE ADMINISTRATOR

November 1, 1996

TO: **Tim Cross**
Assistant Inspector General
for Inspection & Evaluation

FROM: **John R. Cox**
Associate Administrator
for Financial Assistance

SUBJECT: **Best Practices Inspection**

The above inspection report has been reviewed by this office and under separate cover, we have transmitted to you suggestions for changes that we believe will better describe certain elements of our programs and how they relate to the report findings. We have attached an updated version of the comments.

In general, we found several comments in the report contributed to those persons being interviewed that we believe indeed describes "best practices" found in the lending industry. We will review these comments more closely and see how or whether they can be used given the public policy mandate given to the Agency.

Since the persons that were interviewed were not randomly selected, some of the views expressed in the report, may not be shared by the industry or SBA in general, and therefore the Agency should not automatically assume that all views expressed are those of "best practices" of the industry or ones that should be adopted by the Agency.

We thank you for the opportunity to review the report. Once the final report is issued, we will make it available to trade associations supported by our participating lenders.

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

October 31, 1996

TO: **Tim Cross**
Assistant Inspector General
for Inspection & Evaluation

FROM: **John R. Cox**
Associate Administrator
for Financial Assistance

SUBJECT: Best Practices Inspection

We have reviewed the draft report on Best Practices and submit the following comments:

- Page iii, line 2 should read "up to 90%" to reflect the most recent legislation that provides for a 90% guaranty on EWCP loans.

  The third paragraph mixes authority with appropriation levels and actual loan activity. We suggest that this be corrected by the following paragraph.

  'The 7(a) program has grown dramatically over the last few years, with the approved 7(a) loans increasing from $5.9 billion in Fiscal Year (FY) 1992 to $7.7 billion in FY 1996, although the Agency had received appropriations for a $10.8 billion program for that year. An appropriations level of $7.7 billion has been approved for FY, 1997. Even if the percentage of non-performing loans SBA purchases from lenders remains constant or declines, the Agency may face major dollar losses simply due to the increase in the program's size.'

- Page v, #3....The comments as to packagers, especially the comment that they do not assume a credit risk is pointless. A lawyer representing a criminal is not expected to share in a sentence handed down by the court. Why would a creditor expect them to share in the credit risk? A packager is not different than an attorney, an accountant, or an appraiser, that represents an applicant. An attorney, accountant, or other third party prepares statements and represents applicants. There are good ones as well as bad ones, as there are in all walks of life. Individuals rendering these types of services

are not expected to take part of the credit risk in a loan. A statement of this nature detracts from the overall report and leads the reader to think that the report writer or the individuals they interviewed do not know what the real world is about.

I would recommend that the statement be rewritten to reflect that there are mixed feelings on packagers and that one should insist on good loan packagers no matter who prepares the paperwork.

- Page 1 of Background, paragraph 1....make appropriate adjustments to guaranty rates. Third sentence should read..."The guaranty amount is generally limited to $750,000 except for Delta, International Trade and Pollution Control loans."

- Page 1, paragraph 2, at the end of the 3rd sentence we recommend the following be added..."without SBA's approval, **although SBA does review PLP loans for eligibility prior to issuing a loan number."** You may want to use 1996 figures in this paragraph which are, 21% of the numbers and 39% of the dollars.

- Page 1, paragraph 4, rather than use authority numbers for 1996 we recommend you use actual approval numbers. Authority figures do not mean very much when an Agency does not use the money.

- The report uses the terms "non-depository lenders and SBLCs interchangeably, which is incorrect. It should be made clear that there are 14 SBLCs out of 8,000 lenders.

- Page 7, section 3, first paragraph...recommend that you insert the word **"interviewed"** after the word "lenders". Since the sample of lenders were hand picked rather than a controlled sample, I have a concern that the individuals that were interviewed may not reflect the views of most lenders, even lenders with whom we have an excellent track record. For this reason, I request that the following be inserted:

  "The AA/FA believes that packagers serve a worthwhile purpose in serving small business concerns. The quality of any service being provided must be monitored not only by the Agency but also by the lending industry to make sure that the small business community is being given quality service. This holds true for attorney

representation, accounting expertise, lender's services,or any other professional service being given in conjunction with an SBA application."

- Page 8, section 5, second paragraph. The Agency does not allow up-front agreements to release collateral. This certainly should not be included in a "best practices" report. When one pledges collateral, it is pledged period.

- Page 9, first paragraph. This might make one to assume that SBA did not require equity injection in a loan, which we most definitely do. Taking collateral instead of equity injection is a poor practice rather than a best practice.

- Page 9, second paragraph, last sentence. Although in the commercial industry, collateral is very important, our legislation states the following:

  "All loans made under this subsection shall be of such sound value or so secured as reasonably to assure repayment...". In other words, if the Agency or lender believes that the loan can be repaid from the earnings of the business, collateral is not an issue. This lender is confusing commercial practice with the Law under which SBA operates. For SBA purposes, best practices as seen in the commercial market may not be the best practices in carrying out the intent of Congress and the Administration.

- Page 16, last paragraph. We would ask that at the end of the last sentence the following be inserted to better reflect what the program office is currently doing to assist in improving some of the direction to lenders and field offices.

  "OFA is also finalizing new standard operating procedures, (SOPs). In its recent training to SBA field staff and lenders on the program, OFA stressed the critical need for uniform adherence to regulation and SOP requirements to ensure national consistency in program implementation."

Sorry that it took me so long in getting this to you. Thank you for the opportunity to comment.

APPENDIX E

OIG RESPONSE TO OFFICE OF FINANCIAL ASSISTANCE COMMENTS

The Associate Administrator for Financial Assistance (AA/FA) made a number of technical comments, many of which have been incorporated into the report.

Based on some of his other comments, however, it appears there may have been some misunderstanding as to what the inspection sought to accomplish. The specific objective was to identify the practices of some of SBA's best Section 7(a) lenders--lenders selected with the help of Office of Financial Assistance (OFA) and district office officials--so that other 7(a) lenders might replicate and improve their practices and, conversely, so that SBA could identify lenders likely to pose a higher risk of loan defaults. The Office of Inspector General's (OIG) larger purpose was to help the 7(a) program to minimize its loan losses, saving taxpayers money and stretching limited SBA resources to help as many credit-worthy small businesses as possible. The inspection report emphasized that the practices were not an exhaustive list of effective practices and that its conclusions could not be projected to all 7(a) lenders. The OIG believes, however, that the practices are a useful guide for SBA lenders needing to develop internal procedures for SBA loans or improve their management of credit.

Two best practices in particular disturbed the AA/FA. First, he took issue with the finding that the successful lenders in our sample generally avoid the use of external loan packagers. He argued that packagers serve a worthwhile purpose. In many cases this may be true, but most of the lenders in our sample expressed misgivings about loan packagers, with the major thrust of their assertions directed at full-time packagers as opposed to accountants or others who only occasionally prepare loan applications. In October 1995 testimony before Congress, the Deputy Inspector General stated that, in the 7(a) program alone, criminal investigations had been initiated on 323 individuals involving loan applications prepared by 19 packagers for a potential loss to the Government of as much as $125 million. SBA, too, was sufficiently concerned about fraudulent loan packagers to form a committee in 1995 to examine the problem. In short, the inspection's findings reflect the comments of a diverse group of successful lenders who make small business loans in agricultural, suburban, and urban--including inner city--areas. Given this group's explicit doubts about loan packagers, their concerns cannot in good faith be ignored.

Second, the AA/FA challenged the finding that all the lenders in the sample required borrowers to pledge personal and business assets whenever collateral is needed. The OIG is not suggesting that collateral is a substitute for a borrower's character or cash flow. Nonetheless, the successful lenders in our sample believed that obtaining collateral was important, if for no other reason than to impress on borrowers the seriousness of the loan commitment. We do not view this practice as detrimental to carrying out the intent of Congress and the Administration; like the lenders, we regard it as just one of a number of considerations required in making a loan.

In summary, the OIG believes that the report's findings, which were based on a sample of demonstrably successful lenders, should be useful to SBA in its efforts to keep loan losses to a minimum. Not all the best practices identified may be applicable to every lender or to all circumstances, but encouraging less successful lenders to adopt some or all of these practices would surely reduce losses and improve overall lender performance.

APPENDIX F

CONTRIBUTORS TO THIS REPORT

Phil Neel, Team Leader
Ned Nazzaro, Inspector
Holly Mudd, Inspector