United States Government Accountability Office

GAO

Report to Congressional Requesters

February 2009

SMALL BUSINESS ADMINISTRATION

Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight

GAO

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GAO-09-228

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Highlights

Highlights of GAO-09-228, a report to congressional requesters

Why GAO Did This Study

The Small Business Administration's (SBA) 7(a) program is intended to provide loan guarantees to small business borrowers who cannot obtain conventional credit at reasonable terms and do not have the personal resources to provide financing themselves. In fiscal year 2008, SBA guaranteed over 69,000 loans valued at about $13 billion. To assist in oversight of the 7(a) program, GAO was asked to (1) describe SBA's criteria and lenders' practices for determining that borrowers cannot obtain credit elsewhere and (2) examine SBA's efforts to ensure that lenders are complying with the credit elsewhere provision. To meet these objectives, GAO reviewed applicable statutes and guidance, visited 18 lenders and reviewed 238 of their loan files, reviewed 97 on-site lender review reports, and interviewed SBA officials. GAO's samples of lenders and loan files were not generalizable.

What GAO Recommends

GAO recommends that SBA issue more detailed guidance to lenders on how to document their compliance with the credit elsewhere requirement. In responding to a draft of this report, SBA stated that it would use GAO's findings to create more specific guidance for lenders.

To view the full product, including the scope and methodology, click on GAO-09-228. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

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What GAO Found

The Small Business Act and 7(a) program regulations and guidance allow lenders to use their conventional lending practices to determine whether borrowers can obtain credit elsewhere at reasonable terms. On the basis of a review of 238 loan files at 18 lenders, GAO observed that the most common reasons these lenders cited to substantiate that borrowers could not obtain credit elsewhere were that the borrower needed a longer maturity than the lender's policy permitted and the borrower's collateral did not meet the lender's requirements. These factors are two of the six listed in SBA's guidance as acceptable to substantiate that a borrower could not obtain conventional credit.

SBA has issued little guidance on how lenders should document in their files that borrowers could not obtain credit elsewhere. Internal control standards for federal agencies specify that good guidance (information and communication) is necessary to help ensure the proper implementation of program rules. While SBA's guidance requires lenders to explain why the borrower could not obtain credit elsewhere in the loan file, it does not specify what exactly lenders should include in their explanations. Between October 2006 and March 2008, SBA reviewed 97 lenders and determined that 31 of them had failed to consistently document that borrowers met the credit elsewhere requirement or personal resources test. All but one of the lenders with whom GAO met documented their credit elsewhere decisions in some way; however, given the broad authority granted to lenders, the explanations were generally not specific enough to reasonably support the lender's conclusion that borrowers could not obtain credit elsewhere. A number of these lenders used a checklist that simply listed the six acceptable reasons cited in SBA's guidance for substantiating that a borrower could not obtain credit elsewhere and did not prompt them to provide more information specific to the borrower—for example, details on insufficient collateral. Absent detailed guidance on what exactly SBA wants lenders to document in their credit elsewhere determinations, lenders likely will continue to offer limited information in their files, making meaningful oversight of compliance with the credit elsewhere requirement difficult.

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Abbreviations

CDC	certified development company
DSCR	debt service coverage ratio
LAS	Loan Accounting System
LIBOR	London Interbank Offered Rate
OCRM	Office of Credit Risk Management
PLP	preferred lender program
SBA	Small Business Administration
SBLC	small business lending company
SOP	Standard Operating Procedure
TALF	Term Asset-Backed Securities Loan Facility

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

February 12, 2009

The Honorable Thomas A. Carper
Chairman
Subcommittee on Federal Financial Management,
Government Information, Federal Services, and
International Security
Committee on Homeland Security and
Governmental Affairs
United States Senate

The Honorable Tom Coburn, M.D.
United States Senate

The recent tightening of the credit markets has raised concerns about the ability of small businesses to obtain credit and has increased attention on alternative sources of credit for this segment of the economy. The Small Business Administration (SBA) was created in 1953 to assist and protect the interests of small businesses, in part by addressing constraints in the supply of credit for these firms. The 7(a) program, named after the section of the Small Business Act that authorized it, is SBA's largest business loan program.[1] The program is intended to serve creditworthy small business borrowers who cannot obtain credit through a conventional lender at reasonable terms and do not have the personal resources to provide financing themselves.[2] In fiscal year 2008, SBA guaranteed over 69,000 loans valued at about $13 billion.[3] The loan guarantee covers part of a lender's losses in the event of a default, reducing the risk of lending to small businesses that would otherwise not qualify for a conventional loan. To streamline the lending process, SBA works with lenders that have "delegated authority"—that is, the ability to make credit determinations without prior review by SBA. According to SBA, the majority of loans that it guarantees each year are made by lenders with delegated authority.

[1]In 1958, Congress withdrew the Small Business Act of 1953 and enacted the substantially similar Small Business Act of 1958. Pub. L. No. 85-536, 72 Stat. 384 (1958). Section 7(a) of the 1958 act, now codified at 15 U.S.C. § 636(a), provides the authority for the 7(a) program.

[2]In this report, a loan without a federal guarantee is called a conventional loan, conventional credit, or a loan obtained from a conventional lender.

[3]See appendix I for a discussion of 7(a) lending during the current credit crisis.

Because the 7(a) program is intended to serve borrowers who cannot obtain conventional credit at reasonable terms, lenders making 7(a) loans must ensure that borrowers meet the “credit elsewhere” requirement. This requirement stipulates that to receive 7(a) loans, borrowers must not be able to obtain financing under reasonable terms and conditions from conventional lenders.[4] In addition, because 7(a) borrowers must not have the personal resources to cover the needed funding, lenders also must apply a “personal resources” test to confirm that the desired funds are not available from any principal of the business. Lenders may reject a small business’s application for a conventional loan for a variety of reasons. For example, a business may need a loan with longer maturity than the lender’s policy permits or an amount that exceeds the lender’s legal lending limit or policy limit for a single customer. Lenders also may require more collateral than a small business can offer or may not lend to start-ups or firms in certain industries.

To assist you in overseeing the 7(a) program, you asked us to review how lenders implement and SBA oversees the program’s credit elsewhere provision. Specifically, this report (1) describes SBA’s criteria for determining that borrowers cannot obtain credit elsewhere and practices lenders employ to determine that borrowers cannot obtain credit elsewhere and (2) examines SBA’s efforts to ensure that lenders are complying with the credit elsewhere provision.

To address these objectives, we reviewed applicable statutes and the legislative history of the 7(a) program, SBA’s regulations and guidance for administering the program, our previous reports, and studies of the program conducted by the SBA Inspector General and external organizations. To determine lender practices for implementing the credit elsewhere provision, we visited 18 lenders with delegated authority and reviewed 238 of their approved applications for 7(a) loans. We selected these lenders based on the size of their SBA loan portfolios and geography, among other things. The number of files we reviewed at each lender was based on the size of the lender’s portfolio; we reviewed more files at larger lenders than we did at smaller lenders. While our samples of 18 lenders and 238 loans files are nongeneralizable, they offer perspectives on how some lenders implement the credit elsewhere provision. We interviewed

[4] Reasonable terms and conditions are to be determined by the lender, taking into consideration “the prevailing rates and terms in the community in or near which the concern transacts business, or the homeowner resides, for similar purposes and periods of time.” 15 U.S.C. § 632(h).

SBA officials and contractor staff to discuss lender oversight efforts and reviewed all 97 on-site review reports completed between October 2006 and March 2008 and related correspondence and enforcement action data. Appendix II discusses our scope and methodology in further detail.

We conducted our work in Atlanta, Georgia; Chicago, Illinois; Houston, Texas; Los Angeles, California; New York City, New York; San Francisco, California; and Washington, D.C., between February 2008 and February 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

The Small Business Act and 7(a) program regulations and guidance allow lenders to use their conventional lending practices to determine whether borrowers can obtain credit elsewhere at reasonable terms. That is, if a borrower does not meet the requirements of the lender's conventional loan policy, the lender will assume that conventional credit is unavailable to that borrower. The Small Business Act and its business lending regulations specify that SBA shall provide business loan assistance only to borrowers who cannot obtain credit elsewhere, defining credit elsewhere as the availability of credit from nonfederal sources on reasonable terms and conditions. SBA's primary operational guidance for the 7(a) program—Standard Operating Procedure (SOP) 50-10—builds upon the language of the statute and regulations by outlining six reasons lenders can use to substantiate that a borrower cannot obtain credit elsewhere. Together, the statute, regulations, and guidance allow lenders to use their own conventional lending policies to make case-by-case decisions about which borrowers need an SBA guarantee. During our review of 238 files at 18 lenders, we observed that the most common reasons these lenders cited to substantiate that borrowers could not obtain credit elsewhere were that the borrower needed a longer maturity than the lender's policy permitted and the borrower's collateral did not meet the lender's requirements.

SBA has issued little guidance on how lenders should document in their files that borrowers could not obtain credit elsewhere. Internal control standards for federal agencies specify that good guidance (information and communication) is necessary to help ensure the proper implementation of program rules, including eligibility requirements.[5] According to SBA's SOP 50-10, lenders are required to substantiate the reasons a borrower cannot obtain credit elsewhere at reasonable terms and retain the explanation in the borrower's loan file. However, the SOP does not specify what exactly lenders should include in their explanations. SBA has not issued any other guidance on documenting compliance with the credit elsewhere provision. SBA's own on-site reviews of lenders—its primary means of assessing compliance with the credit elsewhere requirement—indicated that documenting credit elsewhere determinations was a problem. Between October 2006 and March 2008, SBA determined that 31 of the 97 lenders reviewed had failed to consistently document that borrowers met the credit elsewhere requirement or personal resources test. The results of our file reviews at 18 lenders, which included many lenders who were previously reviewed by SBA, showed that all but one of the lenders had documented their credit elsewhere decisions in some way. However, the explanations they provided were generally not specific enough to reasonably support the lender's conclusion that borrowers could not obtain credit elsewhere. A number of these lenders used a checklist to document their decisions. However, these checklists simply list the six acceptable reasons cited in SOP 50-10 for substantiating that a borrower could not obtain credit elsewhere and do not prompt them to provide more information specific to the borrower—for example, how a longer maturity would improve a business's ability to repay a loan or the details on insufficient collateral. Such information could help support the lender's assessment that the borrower could not obtain credit elsewhere. Absent detailed guidance on what exactly SBA wants lenders to document in their credit elsewhere determinations, lenders likely will continue to offer limited information in their files, making meaningful oversight of compliance with the credit elsewhere requirement difficult.

This report includes one recommendation designed to improve SBA's oversight of compliance with the credit elsewhere provision. We recommend that SBA issue more detailed guidance to lenders on how to document their compliance with the credit elsewhere requirement. We provided SBA with a draft of this report for its review and comment. In written comments, SBA stated it would work with its incoming

[5]GAO, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

administrative leadership to use our findings to create more specific guidance for lenders.

Background

The Small Business Act created SBA to aid, counsel, assist, and protect the interests of small business concerns. The first version of Section 7(a) of the act empowered SBA to make loans to small businesses with the restriction that "no financial assistance shall be extended … unless the financial assistance applied for is not otherwise available on reasonable terms." While there have been numerous amendments to Section 7(a), the credit elsewhere restriction has remained, with slight modifications. For instance, the phrase "credit elsewhere" was introduced in 1981 and the provision was changed to read that "[n]o financial assistance shall be extended pursuant to this subsection if the applicant can obtain credit elsewhere."[6] At the same time, a definition of credit elsewhere was added.

The 7(a) program's legislative history emphasizes the program's role in meeting the credit needs of certain small businesses. The legislative basis for the program recognizes that the conventional lending market is the principal source of financing for small businesses and that the loan assistance that SBA provides is intended to supplement rather than compete with that market. As the legislative history suggests, conventional lending may not be a feasible financing option for some small businesses under certain circumstances. The design of the 7(a) program is consistent with the statute and its legislative history. First, the loan guarantee limits the lender's risk in extending credit to a small firm that may not have met the lender's own requirements for a conventional loan. Second, the credit elsewhere requirement is intended to provide some assurance that guaranteed loans are offered only to firms that are unable to access credit on reasonable terms and conditions in the conventional lending markets. Third, an active secondary market for the guaranteed portion of a 7(a) loan allows lenders to sell the guaranteed portion of the loan to investors, providing additional liquidity that lenders can use for additional loans.

Under the 7(a) program, SBA guarantees loans made by commercial lenders to small businesses for working capital and other general business

[6]The Small Business Budget Reconciliation and Loan Consolidation/Improvement Act of 1981, Pub. L. No. 97-35, title XIX, § 1902, 95 Stat. 767 (1981).

purposes.[7] These lenders are mostly banks, but some are nondepository lenders, including small business lending companies (SBLC)—nondepository lenders previously chartered by SBA to provide 7(a) loans to qualified small businesses. The guarantee assures the lender that if a borrower defaults on a loan, the lender will receive an agreed-upon portion (generally between 50 percent and 85 percent) of the outstanding balance. For a majority of 7(a) loans, SBA relies on lenders with delegated authority to process and service 7(a) loans and to ensure that borrowers meet the program's eligibility requirements. To be eligible for the 7(a) program, a business must be an operating for-profit small firm (according to SBA's size standards) located in the United States and meet the credit elsewhere requirement, including the personal resources test.[8]

SBA is not authorized to extend credit to businesses if the financial strength of the individual owners or the firm itself is sufficient to provide or obtain all or part of the financing or if the business can access conventional credit. To assess whether borrowers can obtain credit elsewhere, lenders must determine that the desired credit, for a similar purpose and period of time, is unavailable to the firm on reasonable terms and conditions from nonfederal sources without SBA assistance, taking into consideration prevailing rates and terms in the community or locale where the firm conducts business. Nonfederal sources may include any lending institutions. In addition, lenders must determine that the firm's owners are unable to provide the desired funds from their personal resources. When applying this personal resources test, the lender must assess the liquid assets of each owner of 20 percent or more of the equity of the applicant company to determine the overall dollar value of the allowable exemption, which is defined as the amount of personal resources that do not have to be injected into the business. The allowable exemption is determined on the basis of the "total financing package." The total financing package includes any SBA loans, together with any other loans, equity injection, or business funds used or arranged for at the same

[7] Although SBA has limited legislative authority to make direct loans to borrowers unable to obtain loans from conventional lenders, SBA has not received any funding for these programs since fiscal year 1996.

[8] In establishing size standards, SBA considers economic characteristics of the industry, including degree of competition, average firm size, start-up costs and entry barriers, and distribution of firms by size. It also considers growth trends, competition from other industries, and other factors that may distinguish small firms from other firms. SBA's size standards seek to ensure that a firm that meets a specific size standard is not dominant in its field of operation.

general time for the same project as the SBA loan. If the total financing package

- is $250,000 or less, the exemption is two times the total financing package or $100,000, whichever is greater;
- is between $250,001 and $500,000, the exemption is one and one-half times the total financing package or $500,000, whichever is greater; or
- exceeds $500,000, the exemption equals the total financing package or $750,000, whichever is greater.

Once the exemption is determined, it is subtracted from the liquid assets. If the result is positive, that amount must be injected into the project.

When the 7(a) program was first implemented, borrowers were generally required to show proof of credit denials (rejection documentation) from no fewer than two banks that documented, among other things, the reasons for not granting the desired credit. Similar requirements remained in effect until 1985, when SBA amended the rule to permit a lender's certification made in its application for an SBA guarantee to be sufficient documentation.[9] This certification requirement remained when the rule was rewritten in 1996. SBA stated that requiring proof of loan denials was demoralizing to small businesses and unenforceable by SBA.

Within the 7(a) program, there are several delivery methods—including regular 7(a), the preferred lender program (PLP), and SBAExpress. Under the regular (nondelegated) 7(a) program, SBA makes the loan approval decision, including the credit determination. Under PLP and SBAExpress, SBA delegates to the lender the authority to make loan approval decisions, including credit determinations, without prior review by SBA. The maximum loan amount under the SBAExpress program is $350,000 (as opposed to $2 million for other 7(a) loans). The program allows lenders to utilize, to the maximum extent possible, their respective loan analyses, procedures, and documentation. In return for the expanded authority and autonomy provided by the program, SBAExpress lenders agree to accept a maximum SBA guarantee of 50 percent. (Other 7(a) loans have a

[9]By signing the loan guarantee application, the lender is certifying that "without the participation of SBA to the extent applied for, we would not be willing to make this loan, and in our opinion the financial assistance applied for is not otherwise available on reasonable terms."

maximum guarantee of 75 or 85 percent, depending on the loan amount.) According to SBA, as of December 31, 2007, there were 672 PLP and 1,889 SBAExpress lenders. Of these, 603 lenders were approved for both programs.

In the federal budget, the 7(a) program is currently a "zero subsidy" program, meaning that the program does not require annual appropriations of budget authority for new loan guarantees. To offset some of the costs of the program, such as default costs, SBA assesses lenders two fees on each 7(a) loan. The guarantee fee must be paid by the lender at the time of loan application or within 90 days of the loan being approved, depending upon the loan term. This fee is based on the amount of the loan and the level of the guarantee, and lenders can pass the fee on to the borrower. The ongoing servicing fee must be paid annually by the lender and is based on the outstanding balance of the guaranteed portion of the loan.

SBA's Office of Credit Risk Management (OCRM) is responsible for overseeing 7(a) lenders, including those with delegated authority. SBA created this office in fiscal year 1999 to ensure consistent and appropriate supervision of SBA's lending partners.[10] The office is responsible for managing all activities regarding lender reviews, preparing written reports, evaluating new programs, and recommending changes to existing programs to assess risk potential.

Program Design Allows Lenders to Use Their Conventional Lending Policies to Make Credit Elsewhere Decisions

The Small Business Act and 7(a) program regulations give lenders discretion to determine which borrowers cannot obtain credit elsewhere and thus require an SBA guarantee. SBA's primary guidance for the 7(a) program outlines six reasons lenders can use to substantiate that a borrower cannot obtain credit elsewhere. Together, the statute, regulations, and guidance allow lenders to use their own conventional lending policies to determine which borrowers need an SBA guarantee. Our file reviews showed that lenders most often cited the borrower's need for a longer maturity, lack of collateral, and the age or type of business as reasons for requiring an SBA guarantee.

[10] Prior to a reorganization in May 2007, the office was called the Office of Lender Oversight.

SBA's Credit Elsewhere Requirement Gives Broad Authority to Lenders

The Small Business Act specifies that SBA shall not make or guarantee loans for borrowers who are able to obtain credit elsewhere.[11] The statute defines credit elsewhere as

> "the availability of credit from non-Federal sources on reasonable terms and conditions taking into consideration the prevailing rates and terms in the community in or near where the concern transacts business, or the homeowner resides, for similar purposes and periods of time."

Consistent with the statute, the governing regulations note that SBA will guarantee loans only for applicants for whom the desired credit is not otherwise available on reasonable terms from a nonfederal source.[12] According to SBA, the credit elsewhere requirement was specifically designed to be broad in order not to limit lenders' discretion and to allow for differences in geographic regions, economic conditions, and types of businesses.

SBA's primary operational guidance for the 7(a) program—SOP 50-10—builds upon the statute and regulations by outlining six reasons lenders can use to substantiate that a borrower cannot obtain credit elsewhere on reasonable terms.[13] These reasons can be divided into two groups: those that are specific to the borrower's creditworthiness or business and those that are specific to the lender's financial position and unrelated to a borrower's creditworthiness or the availability of loans from other sources. Reasons related to the borrower are that

- The business needs a longer maturity than the lender's policy permits.
- The collateral does not meet the requirements of the lender's policies.

[11] 15 U.S.C. § 636 (a)(1).

[12] 13 C.F.R. § 120.101. Neither the statute nor the regulations specifically define "reasonable terms."

[13] SOP 50-10 defines "unreasonable terms" as the following: (1) debt structured with a demand note or a balloon payment, (2) debt for which the payments exceed the borrower's ability to pay, (3) debt with an interest rate that is significantly above the market rate, (4) credit card debt, and (5) interest-only term debt (SBA does not consider interest-only lines of credit to have unreasonable terms). See SOP 50-10(5), *Lender and Development Company Loan Programs* (Aug. 1, 2008), 127. SBA recently revised SOP 50-10, creating a new version 5 effective August 2008.

- The lender's policies normally do not allow loans to new businesses or businesses in the applicant's industry.
- Any other factors relating to the credit that, in the lender's opinion, cannot be overcome without the guarantee.

The lender may also use one of the following lender-related reasons: The requested loan amount exceeds the lender's legal lending limit or policy limit on the amount it can lend to one customer, or the lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market.[14]

Lenders Assess Availability of Credit Elsewhere against Their Own Underwriting Standards

On the basis of interviews with a sample of lenders and reviews of a sample of 7(a) loan files, we found that lenders evaluate a borrower's ability to obtain credit elsewhere on reasonable terms against their own conventional lending policies. This finding was generally consistent with those of a recent Urban Institute report.[15] Lenders we visited most often cited the borrower's need for a longer maturity, lack of collateral, and the age or type of business as reasons for requiring an SBA guarantee.

[14]The legal lending limit for national banks is set forth at 12 U.S.C. § 84. Legal lending limits are generally high—12 U.S.C. § 84(a) specifies that loans to one borrower generally cannot exceed 15 percent of the bank's capital and that lenders can make additional loans to a borrower totaling up to 10 percent of the bank's capital if those additional loans are fully secured by "readily marketable collateral." The legal lending limit also generally applies to Federal Deposit Insurance Corporation-insured thrift institutions. See 12 U.S.C. § 1464(u). State law applies legal lending limits to state-regulated banks. Lenders are permitted to sell the guaranteed portion of 7(a) loans on the secondary market pursuant to 13 C.F.R. Part 120, Subpart F. SOP 50-10 also specifies two "unacceptable factors," or factors lenders cannot use to substantiate that a borrower could not obtain credit elsewhere: (1) to address compliance with the Community Reinvestment Act and (2) to refinance debt already on reasonable terms. The Community Reinvestment Act of 1977 (12 U.S.C. § § 2901 *et seq.*) was designed to encourage community banks and savings associations to meet the needs of borrowers in all segments of their communities, including low- and moderate-income neighborhoods, and was intended to reduce discriminatory credit practices against such neighborhoods.

[15]See the Urban Institute, *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*, Final Report (Washington, D.C.: January 2008). Appendix II contains a technical assessment of this study.

Different Underwriting Policies Result in Different Lending Practices

In practice, lenders evaluate a borrower's ability to obtain credit elsewhere against their own conventional lending policies.[16] That is, if a borrower does not meet the requirements of the lender's conventional loan policy, the lender will require an SBA guarantee (or in some cases, deny the loan request). The criteria or thresholds established in the lender's underwriting policies are representative of the level of risk the lender is willing to assume on a loan. Many factors influence lenders' risk tolerance levels, including the size of the institution, its location, and its financial position. As a result, lenders may focus on different types of lending or see certain types of lending as being more central to their operations than others.

Our findings from interviews with a small, nongeneralizable sample of 18 lenders suggest that differences in lending practices could affect how the credit elsewhere requirement was applied. Some of the lenders said that they relied on automated underwriting systems that primarily considered quantitative factors such as credit scores and financial ratios to determine whether a borrower qualified for a conventional loan or required a guarantee. But some other lenders said that they also considered qualitative factors such as the borrower's relationship with the bank—for example, the amount on deposit or a prior lending history—when determining whether to extend conventional or guaranteed credit.

An Urban Institute report on lenders' implementation of the credit elsewhere requirement reached similar conclusions. On the basis of interviews with 23 banks that originated both SBA and conventional loans, the Urban Institute concluded that lenders that employed small business credit-scoring models often had relatively straightforward rules regarding the types of borrowers that were eligible for conventional and guaranteed loans. However, it also noted that lenders (in particular smaller lenders) that continued to use relationship underwriting were less likely to have objective thresholds borrowers had to meet in order to qualify for conventional financing.[17]

[16]According to SBA guidance, "lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards." See SOP 50-10(5), chapter 4, Credit Standards, Collateral, and Environmental Policies.

[17]The Urban Institute described relationship underwriting as a process during which a lender works with a small business customer in order to provide the most appropriate types of financing, given the firm's expected cash flow from operations.

Lenders Cite Similar Reasons to Substantiate Credit Elsewhere Decisions

Using information collected from 238 recently approved 7(a) loan files from 18 lenders, we found that the most common reasons lenders cited to substantiate that borrowers could not obtain credit elsewhere were (1) that the business needed a longer maturity than the lender's policy permitted, (2) that the borrower's collateral did not meet the lender's policies, and (3) that the lender's policies did not normally allow loans to new businesses or businesses in the applicant's industry (see table 1).[18]

Table 1: Reasons Lenders Gave to Explain Why Borrowers Could Not Obtain Credit Elsewhere

Reason	Number of times cited in selected files
The business needs a longer maturity than the lender's policy permits.	142
The collateral does not meet the requirements of the lender's policies.	110
The lender's policies normally do not allow loans to new businesses or businesses in the applicant's industry.	47[a]
The lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market.	28[b]
The requested loan exceeds either the lender's legal lending limit or policy limit regarding the amount it can lend to one customer.	1
Other[c]	26
Total	**354[d]**

Source: GAO analysis of data from selected lenders.

[a] Forty of the 47 files cited "the lender's policies normally do not allow loans to new businesses." The remaining 7 cited "the lender's policies normally do not allow loans to businesses in the applicant's industry."

[b] Two SBLCs and one bank cited "the lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market" to substantiate that borrowers could not obtain credit elsewhere. One SBLC cited this reason 15 times, the other SBLC cited it 3 times, and the bank cited it 10 times.

[c] Some of the other reasons lenders cited included an insufficient credit score or blemished credit and lack of a down payment.

[d] The total number of reasons cited (354) exceeds the total number of files we reviewed (238) because lenders can and sometimes did cite more than one reason to substantiate that a borrower could not obtain credit elsewhere.

[18] The sample of 18 lenders with whom we met was not statistically representative and not large enough to generalize to all lenders. Nor was the number of files we reviewed at each lender representative of all borrowers served by each individual lender. The files we reviewed generally were approved in calendar years 2007 and 2008.

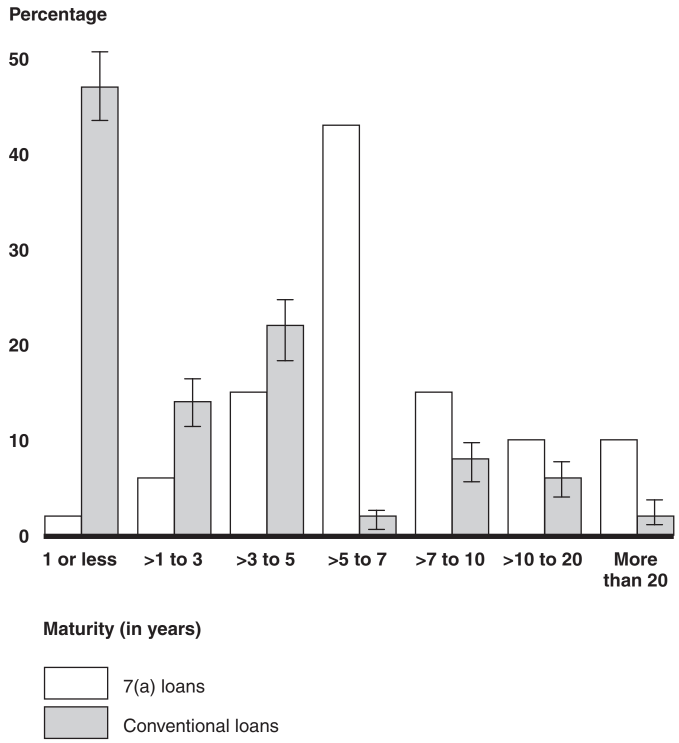
The results of our file reviews generally were consistent with the findings of the Urban Institute's report on lenders' implementation of the credit elsewhere requirement. The Urban Institute concluded that the most common reasons lenders cited to substantiate that borrowers could not obtain credit elsewhere were that the business needed a longer maturity than the lender's policy permitted and that the borrower's collateral did not meet the lender's underwriting requirements.[19]

As table 1 shows, the most common reason that lenders we visited cited to substantiate that a borrower could not obtain credit elsewhere was that the borrower needed a longer term (maturity) than the lender could provide with a conventional loan. In general, SBA-guaranteed loans provide more generous terms to borrowers than conventional loans. In 2007, we found that almost 80 percent of 7(a) loans had maturities of more than 5 years, compared with 5 years or less for an estimated 83 percent of conventional loans (see fig. 1).[20]

[19]The Urban Institute noted an additional common reason lenders cited to substantiate that borrowers could not obtain credit elsewhere: For real estate loans, the borrower did not have sufficient equity for the required down payment.

[20]GAO, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*, GAO-07-769 (Washington, D.C.: July 13, 2007).

Figure 1: Percentage of 7(a) and Conventional Loans by Loan Maturity Category, Calendar Years 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data.

Note: The brackets on the conventional loans represent the 95 percent confidence interval. See GAO-07-769 for more information.

In general, longer terms mean lower payments, which allow borrowers to service debt with a lower net operating income (see table 2).

Table 2: Impact of Loan Term on Annual Payment and Required Net Operating Income

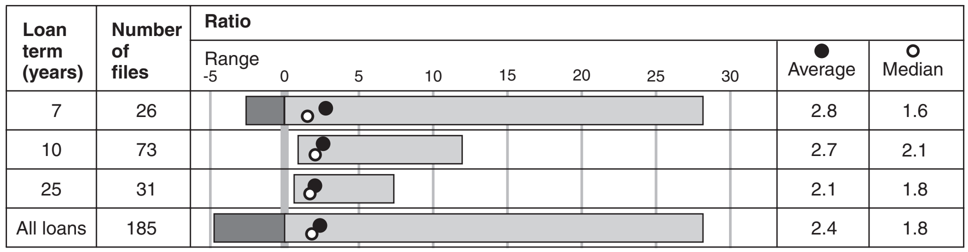
	Example			
Loan attributes	**1**	**2**	**3**	**4**
Loan amount	$300,000	$300,000	$300,000	$300,000
Interest rate (percent)	8.0	8.0	8.0	8.0
Maturity (years)	3	5	7	10
Annual payment (fully amortized)	$112,800	$72,984	$56,100	$43,668
Net operating income necessary to meet debt service payments (assumes 1.25 debt service coverage ratio)	$141,000	$91,230	$70,125	$54,585

Source: GAO analysis.

Note: Our analysis is similar to that presented in the January 2008 Urban Institute report referenced previously.

Many lenders with whom we spoke said that they generally required a business to have an actual or projected debt service coverage ratio (DSCR) of at least 1.10 to 1.25 to obtain a conventional or guaranteed loan. DSCR is the ratio of net operating income (or cash flow) to debt payments, with a lower ratio indicating less ability to meet debt service payments. Our analysis of DSCRs showed that both the average and the mean ratios for all borrowers in our sample were higher than the 1.10 to 1.25 lender requirement (see fig. 2). We also found that lenders sometimes deviated quite substantially from their required minimums. In some instances, lenders provided loans to businesses with low or negative ratios, suggesting that those borrowers compensated for a lack of cash flow in the short term with collateral, for example. In other instances, lenders provided loans to businesses with ratios well above the minimum requirement, suggesting that factors other than cash flow were behind the reasons for requiring an SBA guarantee.

Figure 2: Debt Service Coverage Ratios for Sample Borrowers



Source: GAO analysis of data from selected lenders.

Note: Of the 238 files we reviewed, 185 files included a DSCR. The sample of loans is not representative of all loans made by the lenders we visited. The files we reviewed generally were approved in calendar years 2007 and 2008.

Of the loans that we reviewed, 46 percent were cited as having insufficient collateral (because of its low value or uniqueness) for a conventional loan. SOP 50-10 stipulates that a 7(a) loan request cannot be denied on the basis of inadequate collateral, noting that one of the primary reasons lenders used the 7(a) program was to provide credit to small businesses that could repay a loan but lacked the collateral needed to cover it in case of default.[21] One lender that we interviewed required all conventional loans to be fully securitized. If a borrower was unable to provide 100 percent collateral against the value of the loan, the lender would require an SBA guarantee. Other lenders had more lenient policies relating to collateral, allowing borrowers to obtain conventional financing with more limited collateral.

Finally, as shown in table 3, our review of lender files showed that all but 2 of the 18 lenders made at least one 7(a) loan to a new business, but that some made significantly more of these loans than others. Many lenders we interviewed said that their conventional lending policies prohibited them from making conventional loans to new businesses.

[21]SOP 50-10(5), 174.

Table 3: Number of 7(a) Loans to New Businesses by Lender

Lender	Number of loans to new businesses	Number of loans to existing businesses
1	3	12
2	3	2
3	3	11
4	1	14
5	0	5
6	3	12
7	1	3
8	3	12
9	1	14
10	0	20
11	6	9
12	2	3
13	2	3
14	3	2
15	5	16
16	2	12
17	17	3
18	18	12
All	**73 (31 percent)**	**165 (69 percent)**

Source: GAO analysis of data from selected lenders.

Note: The sample of loans is not representative of all loans made by each of the lenders. The files we reviewed generally were approved in calendar years 2007 and 2008.

Limited Guidance Impedes Effective Oversight of Lenders' Compliance with the Credit Elsewhere Requirement

A lack of guidance to lenders on how to document compliance with the credit elsewhere requirement impedes SBA's oversight of compliance with the requirement. SBA requires lenders to explain in a borrower's loan file why the borrower could not obtain credit elsewhere on reasonable terms, but its guidance does not provide specific information on what lenders should include in their explanations. Our review of on-site review reports completed during a recent six-quarter period found that SBA determined that 31 of 97 lenders reviewed had not consistently documented that borrowers met either the credit elsewhere requirement or personal resources test. Although all but 1 of the 18 lenders with delegated authority that we interviewed documented their credit elsewhere decisions in some way, the explanations in the files we reviewed were generally not specific enough to reasonably support the lender's conclusion that borrowers could not actually obtain credit elsewhere.

Guidance on Documenting Credit Elsewhere Decisions Is Limited

Internal control standards for federal agencies and programs state that good guidance (information and communication) is a key component of a strong internal control framework.[22] Internal controls are an integral component of an organization's management that provides reasonable assurance that the organization is meeting its objective of ensuring compliance with applicable laws and regulations. For an entity to run and control its operations, it must have relevant, reliable, and timely communications relating to external as well as internal events. Therefore, management should ensure that there are adequate means of communicating with, and obtaining information from, external stakeholders.

Although SBA's guidance requires lenders to document the reasons that borrowers cannot obtain credit elsewhere, it does not specify what exactly lenders should include in their explanations. The only guidance in SOP 50-10 on documenting compliance with the requirement is a sentence stating that the lender is required to substantiate the factors that prevent the borrower from obtaining credit elsewhere and retain the explanation in the small business applicant's file.[23] SBA recently revised SOP 50-10 but did not change the guidance on documenting compliance with the credit elsewhere requirement. According to SBA, SOP 50-10 provides thorough guidance on what is required of lenders for making the credit elsewhere determination and documenting it in the file. To supplement the revised guidance, SBA has issued on its Web site some frequently asked questions about the new SOP. To date, no questions on the credit elsewhere requirement have been posted.

[22]GAO/AIMD-00-21.3.1.

[23]SOP 50-10(5) is consistent with, but generally does not elaborate upon, 13 C.F.R. § 120.101, which requires the lender to certify or otherwise show that the desired credit is not available elsewhere. Submission of an application to SBA by a lender constitutes certification by the lender that it has examined the availability of credit to the applicant, has based its certification upon that examination, and has substantiation in its file to support the certification. The SOP lists six factors that lenders can use to substantiate compliance with the credit elsewhere requirement.

SBA Reviews Have Identified Deficiencies in Documenting Compliance with the Credit Elsewhere Requirement

SBA's Office of Credit Risk Management is responsible for monitoring and evaluating SBA lenders and implementing corrective actions as necessary. Its primary means of ensuring compliance with the credit elsewhere requirement is on-site reviews of large 7(a) lenders—those lenders with outstanding balances on the SBA-guaranteed portions of their loan portfolio amounting to $10 million or more.[24] SBA also conducts on-site reviews of large certified development companies (CDC) that make 504 loans.[25] According to SBA officials, the 7(a) and 504 lenders that SBA plans to review on site over a 2-year period will account for about 85 percent of all guaranteed dollars.[26] SBA relies on a contractor to perform these on-site lender reviews. According to SOP 51 00—SBA's guidance on on-site lender reviews—the purpose of the on-site review is threefold: (1) to enhance SBA's ability to gauge the overall quality of the lender's 7(a) or 504 portfolio; (2) to identify weaknesses in an SBA lender's SBA operations before serious problems develop that expose SBA to losses that exceed those inherent in a reasonable and prudent SBA loan portfolio; and (3) to ensure that prompt and effective corrective actions are taken, as appropriate.[27] In prioritizing lenders for review, SBA primarily considers the following factors: portfolio size, risk rating, date of last review, and findings from previous reviews. In addition to assessing performance, SBA also prepares a written report and follows up with the SBA lender to address weaknesses or deficiencies identified during the review.

As part of these oversight reviews, the SOP requires SBA to determine whether lender policies and practices adhere to SBA's credit elsewhere requirement. This includes checking to see whether lenders have applied a personal resources test to confirm that the desired funds were not available from any principal of the business. With respect to the credit elsewhere

[24]SBA also conducts some on-site examinations of SBLCs with outstanding balances of less than $10 million.

[25]The 504 loan program finances long-term fixed assets through a combination of public and private sector financing. The 504 loans are issued through a partnership with CDCs and private sector third-party lenders. CDCs are nonprofit corporations certified and regulated by SBA to package, process, close, and service 504 loans. SBA performs off-site monitoring of about 4,500 smaller 7(a) and 504 lenders, but this monitoring does not assess compliance with the credit elsewhere requirement.

[26]According to SBA, it began performing on-site risk-based reviews of 7(a) lenders in fiscal year 2005 and implemented fee-based reviews in late fiscal year 2007. Over a 2-year period (fiscal years 2008 and 2009), SBA plans to review all large 7(a) lenders, subject to available resources.

[27]See SOP 51 00, *On-Site Lender Reviews/Examinations* (Sept. 28, 2006).

review, SBA's contractor explained that it checks to see that the lender documented its credit elsewhere determination and cited one of the six acceptable factors listed in SOP 50-10.[28] However, it does not routinely assess the lender's support for its credit elsewhere determination. Contract staff performing an on-site review use a checklist that requires the examiner to answer yes or no that "written evidence that credit is not otherwise available on terms not considered unreasonable without guarantee provided by SBA" was in the file and that the "personal resources test was applied and enforced according to SBA policy." Contractor officials stated that when the documentation standard is not met, the examiner will sometimes look at the factual support in the file to independently determine whether the credit elsewhere requirement or personal resources test was actually met.

Our review of a sample of SBA's on-site review reports showed that SBA determined that nearly a third of lenders had not properly documented that borrowers met either the credit elsewhere requirement or the personal resources test. We analyzed reports from all the on-site lender reviews SBA conducted during a six-quarter period from October 2006 to March 2008 and found that 31 of the 97 lenders reviewed did not consistently document that borrowers met the credit elsewhere requirement or personal resources test.[29] We had to perform this analysis because, until very recently, SBA did not have a system in which it recorded the results of on-site reviews.[30] One on-site review report we analyzed stated that "the credit elsewhere assessment was missing in 24 percent of the cases reviewed." Another report stated that "the lender failed to properly document the personal resources test in 20 of the 22 cases reviewed." As shown in figure 3, the percentage of files at each lender that were cited for not including credit elsewhere documentation ranged from a low of 3 percent to 89 percent. Similarly, the percentage of lender files that

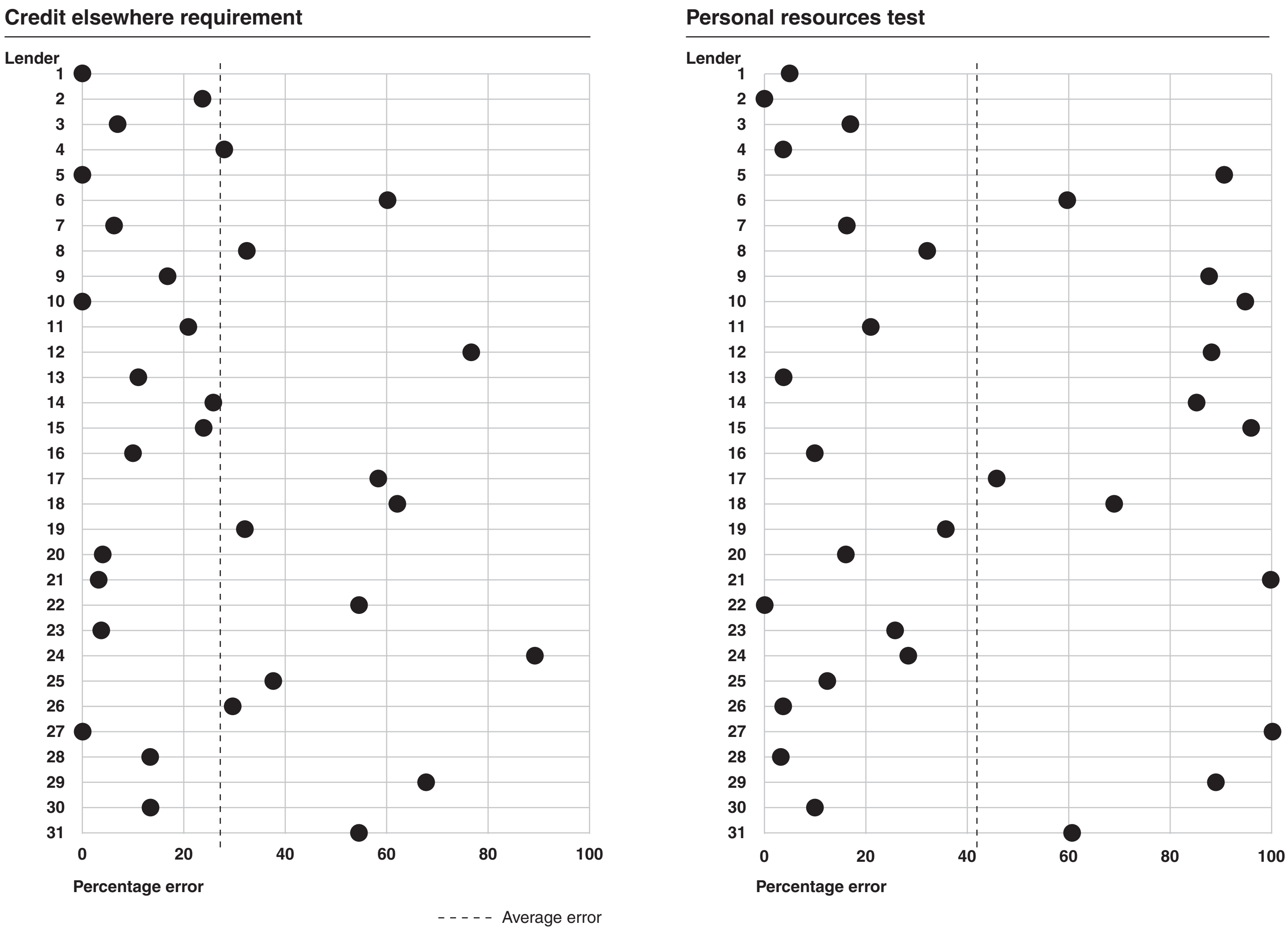
[28]As previously mentioned, the six factors are (1) the business needs a longer maturity than the lender's policy permits, (2) the requested loan exceeds either the lender's legal lending limit or policy limit regarding the amount that it can lend to a single customer, (3) the lender's liquidity depends upon selling the guaranteed portion of the loan on the secondary market, (4) the collateral does not meet the lender's policy requirements, (5) the lender's policy normally does not allow loans to new businesses or businesses in the applicant's industry, or (6) any other factors relating to the credit that, in the lender's opinion, cannot be overcome except for the guarantee.

[29]The on-site review reports for 21 additional lenders identified citations related to the credit elsewhere requirement or personal resources test, but SBA determined that there were not enough citations to warrant a finding.

[30]In late September 2008, SBA populated a database created to track the results of on-site reviews performed from fiscal year 2005 to the present. Because this database was developed at the end of our review, we did not include an assessment of it in this report.

did not include documentation of the personal resources test ranged from a low of 3 percent to 100 percent.

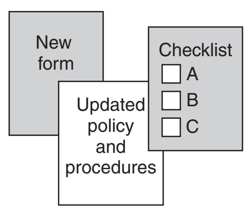
Figure 3: Percentage of Loan Files SBA Reviewed That Did Not Include Documentation for the Credit Elsewhere Requirement or Personal Resources Test, October 1, 2006–March 31, 2008



Source: GAO analysis.

We also found that in each of the 31 cases where there was a finding, SBA required the lender to take corrective action.[31] When conveying the results of an on-site review to a lender, SBA instructs the lender to take corrective actions in response to any findings. The lender then is required to respond to SBA with information on the specific actions it plans to take. In subsequent correspondence with the lender, SBA indicates whether the action taken in response to the finding was satisfactory. As shown in figure 4, corrective actions taken by the 31 lenders with credit elsewhere or personal resources test findings included changes in their procedures to address identified deficiencies, such as updating forms to reflect the credit elsewhere requirement and personal resources test. In all 31 cases, SBA determined that the actions taken by lenders were satisfactory.

Figure 4: Examples of Corrective Actions Taken by Lenders to Address Credit Elsewhere and Personal Resources Test Deficiencies



- Change to credit elsewhere or personal resources test policy or procedures, such as adopting a policy statement or changing the loan approval process.
- Creating a new form such as "SBA Credit Elsewhere Rules Statement" or "Personal Resources Calculation" or a closing checklist.
- Updating existing forms such as delineating a credit elsewhere section in the lender's credit memo.

Source: GAO.

In contrast to SBA's on-site review results, our file reviews revealed that all but one of the lenders included some credit elsewhere documentation in their loan files. We found that besides certifying on the application that credit was not available on reasonable terms from other sources, lenders generally summarized their credit elsewhere determinations in the lender's assessment of the borrower, commonly referred to as a "credit memo." SBA's on-site reviews appear to have had some impact on lender documentation. The majority of lenders we visited told us that SBA's contractor had conducted an on-site review prior to our visit. In addition, representatives of two lenders told us that their on-site reviews had resulted in corrective actions related to the credit elsewhere requirement. An official from one lender stated that it had developed formalized polices

[31]A corrective action is a requirement placed upon a lender to implement, modify, alter, change, or cease a component of its SBA lending activity.

and procedures for its 7(a) lending program and revised its forms and the format of the bank's credit memo to help ensure that their credit elsewhere determinations were documented. Officials representing the other lender stated that they require a checklist for their SBAExpress loans to remind staff to document credit elsewhere decisions.

Lenders' Documentation of Credit Elsewhere Decisions Generally Was Not Specific Enough to Reasonably Support the Determination That Borrowers Could Not Obtain Credit Elsewhere

Although all but one of the lenders we visited documented their credit elsewhere decisions in some way, our review of documentation provided to support credit elsewhere decisions in 238 loan files showed that most lenders did not provide detailed information on why borrowers could not obtain credit elsewhere. For instance, a number of lenders we met with used a checklist to document their credit elsewhere decisions. These checklists allow lenders to select one or more of the six acceptable factors outlined in SBA's SOP 50-10 that "demonstrate an identifiable weakness in the credit of a borrower or exceed the policy limits of the lender." However, they do not prompt lenders to provide more specific information, such as how a longer maturity would improve a business's ability to repay a loan or the details on insufficient collateral.

Some lenders also documented their credit elsewhere decisions in credit memos, but the information provided was generally not very specific. Some examples of credit elsewhere statements in lender files included the following:

- "[The lender] examined the availability of credit and determined that the desired credit is unavailable to the Applicant on reasonable terms and conditions without SBA assistance taking into consideration prevailing rates and terms in the community in and near where the applicant will be conducting business. Specifically, the Applicant would not be able to obtain the proposed financing for this specific purpose without federal assistance."
- "The terms and conditions offered are not available in the marketplace without the assistance of the SBA guarantee."

- “Repayment capability requires maturity that exceeds [the lender’s] policy; value of available collateral is unacceptable; credit unavailable through conventional loan without a lower loan-to-value ratio.”[32]

As evidenced by the above examples, our review of loan files showed that most lenders generally did not provide specific information about the borrower in the statements they included in their explanations, nor did they elaborate upon the items they indicated on the checklist. The lack of details pertaining to the individual borrower or the lender’s financial condition raised questions about the usefulness of the credit elsewhere documentation provided by lenders. Given the broad authority granted to lenders, more information specific to the borrower’s or the lender’s financial condition would help support the lender’s assessment that the borrower could not obtain credit elsewhere. For example, a statement containing both the borrower’s available collateral and the amount of collateral the lender requires for a conventional loan would support the conclusion that the “value of available collateral is unacceptable.”

However, one lender we visited provided more detailed information about borrowers’ credit/financial positions and the reasons that 7(a) loans were more suitable than conventional loans, which provided greater assurance that the borrower could not obtain credit elsewhere. In addition to substantiating that the borrower could not obtain credit elsewhere, the lender provided notes documenting why the borrower was denied a conventional loan. For example:

- Credit elsewhere documentation: “Business is new and does not have sufficient operating history.” Conventional loan denial: “Length of time in business and/or current management; inadequate cash flow; delinquent past or present credit obligations with others; revolving balances to revolving credit limits is high.”
- Credit elsewhere documentation: “Business and personal scores are below the conventional requirement.” Conventional loan denial: “Foreclosure, repossession, collection judgment, terms and conditions requested are not offered on this product. Inadequate cash flow.”

In addition, two other lenders provided more detailed information in some instances. For example:

[32]The loan-to-value ratio is the percentage of a property’s value that is mortgaged. Higher loan-to-value ratios mean a higher risk for the lender.

- "Credit is not available elsewhere due to the fact that the applicant business is not fully secured by the liquidation value of the collateral being pledged. In addition, there is only 1 year old repayment ability from past operations and the applicant requires a maturity greater than the 12 years that [the lender] will go out on commercial loans."

- "[The lender] would not be willing to provide conventional financing on this project at rates and terms acceptable to provide sufficient cash flow for repayment. The fact that the applicants will be injecting 10 percent into the project and have requested a 20 year term does not qualify for conventional financing under our present loan policy. We would not be able to provide funds without the use of the SBA guaranteed loan program."

The results of our file review show that most lenders tend to use generic language to meet credit elsewhere compliance requirements, making it difficult to determine with certainty whether borrowers could not obtain credit elsewhere. When conducting oversight, SBA needs to ensure that lenders are making loans only to borrowers that meet the eligibility requirements of the program. In the absence of detailed guidance on what exactly SBA wants lenders to document or a more prescriptive credit elsewhere requirement, lenders will likely continue to offer limited credit elsewhere statements in their files, making meaningful oversight of compliance with the requirement difficult. For more information on how SBA could create a more prescriptive requirement and the implications of doing so, see appendix III.

Conclusions

The 7(a) program is intended to serve creditworthy small business borrowers who cannot obtain credit through a conventional lender at reasonable terms and do not have the personal resources to provide it themselves. In most cases, SBA relies on the lender to determine if a borrower is eligible for a 7(a) loan, including determining whether the borrower could obtain credit elsewhere. Relying on lenders with delegated authority underscores the importance of SBA guidance and oversight. However, SBA's lack of guidance to lenders on how to document compliance with the credit elsewhere requirement impedes the agency's ability to oversee compliance with the credit elsewhere requirement.

SBA's guidance to lenders on documenting compliance with the credit elsewhere requirement is limited. SOP 50-10 requires lenders to retain explanations of their credit elsewhere determinations in borrowers' loan files but does not specify the amount of detail lenders should include in their explanations. Even with the lack of detail required, the results of SBA's on-site reviews of 7(a) lenders—the agency's primary means of ensuring compliance with the credit elsewhere requirement—indicated that documenting credit elsewhere determinations was a problem for some lenders. Our review of a recent six-quarter period found that SBA had determined that nearly a third of the lenders reviewed had not consistently documented that borrowers met the credit elsewhere requirement or personal resources test. Further, the results of file reviews we conducted at 18 lenders raise questions about the usefulness of credit elsewhere documentation provided by lenders in assessing compliance with the credit elsewhere requirement. We found that lenders tended to provide general statements about a borrower's ability to obtain credit elsewhere, generally citing just one of the six acceptable factors listed in SOP 50-10 without customizing the statement to fit the borrower or lender in question. This practice made it difficult to reasonably conclude that borrowers met the credit elsewhere requirement. The statute, regulations, and guidance allow lenders to use their own conventional lending policies to make case-by-case decisions about which borrowers need an SBA guarantee. Given the broad authority granted to lenders, requiring documentation of the analysis supporting their credit elsewhere decisions could help SBA ensure that the eligibility requirement is being met. By collecting and analyzing this additional information on how lenders are applying the credit elsewhere standard, SBA could better ensure that lenders are complying with the standard. Further, identifying promising practices used by lenders to document their credit elsewhere determinations could help SBA develop more specific guidance for lenders. Absent detailed guidance on what exactly SBA wants lenders to document in their credit elsewhere determinations, lenders will likely continue to offer limited information in their files, making meaningful oversight of compliance with the credit elsewhere requirement difficult.

Recommendation for Executive Action

To improve SBA's oversight of lenders' compliance with the credit elsewhere requirement, we recommend that the SBA Administrator issue more detailed guidance to lenders on how to document their compliance with the credit elsewhere requirement. As part of developing this guidance, SBA could consider (1) requiring lenders to include the analysis that supports their credit elsewhere determinations and (2) identifying promising practices currently being used by lenders. After revising its guidance, SBA also could consider collecting and analyzing any additional information lenders are required to provide on how they apply the credit elsewhere standard.

Agency Comments and Our Evaluation

We requested SBA's comments on a draft of this report, and the Associate Administrator of the Office of Capital Access provided written comments that are presented in appendix IV. SBA stated that it works to establish clear guidelines and standards that ensure documented lender compliance without creating overly burdensome paperwork. It also stated that it would work with its incoming administrative leadership to use our findings to create more specific guidance for lenders on documenting compliance with credit elsewhere standards in a way that achieves this balance.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Chair and Ranking Member, Senate Committee on Small Business and Entrepreneurship; Chairwoman and Ranking Member, House Committee on Small Business; other interested congressional committees; and the Acting Administrator of the Small Business Administration. The report also will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

William B. Shear

William B. Shear
Director, Financial Markets and
Community Investment

Appendix I: 7(a) Lending during the Credit Crisis

Historically, the Small Business Administration's (SBA) 7(a) program has been thought of as a countercyclical program or stimulus, meaning that when conventional credit is tightened, lenders make broader use of the guarantee program to serve the needs of small businesses. However, during this most recent economic downturn, the number and value of approved loans has decreased significantly (see fig. 5).

Figure 5: Number and Dollar Amount of Approved 7(a) Loans as Reported by SBA, Fiscal Years 2003-2008

Fiscal year	Loans			
	Number	Percentage change from previous year	Dollars (in billions)	Percentage change from previous year
2003	67,381	Not applicable	$11.3	Not applicable
2004	81,133	20	13.6	20
2005	95,900	18	15.2	12
2006	97,290	1	14.5	(5)
2007	99,607	2	14.3	(1)
2008	69,434	(30)	12.7	(11)

Source: GAO analysis of SBA data.

SBA and others have speculated as to the reasons for this decline.

- In October 2008, SBA issued a press release citing "a 'perfect storm' of tightened credit by commercial lenders, declining creditworthiness, and reduced demand for loans from small business borrowers uncertain about the future" as the primary reasons for the substantial decrease in 7(a) lending.[1]

- Some lenders have said that the decline in premiums for selling guaranteed portions of loans on the secondary market has reduced incentives for those lenders who depend on premium income to make 7(a) loans. By some estimates, premium rates have declined as much as 60 percent, resulting in significant reductions in income for SBA lenders.

[1] SBA, *Tightened Credit, Reduced Demand Push SBA Loan Volume Down in FY 2008; Agency Works with Banks to Jumpstart Small Business Lending* (Oct. 30, 2008).

- Others cited SBA's new oversight fees as a disincentive to begin or continue 7(a) lending.[2] According to SBA, lenders with 7(a) portfolios of at least $10 million likely will pay oversight fees of between $22,000 and $27,000.

- Finally, some lenders have said that the increased frequency with which SBA has denied or reduced guarantees on defaulted loans for failure to follow the rules for documenting loans has created uncertainty among lenders over whether SBA will honor guarantees, creating disincentives for lenders to participate in the program.

Although the degree to which these reasons may account for the steep decline in 7(a) lending is unclear, SBA and Members of Congress have implemented or proposed measures to stimulate lender and borrower participation in the program.[3] For example:

- SBA issued an interim rule allowing new SBA loans to be made with an alternative base interest rate, the 1-month London Interbank Offered Rate (LIBOR), in addition to the prime rate, which was previously allowed. According to SBA, the prime and LIBOR rates have fluctuated away from their historical relationship, typically 300 basis points, squeezing SBA lenders out of the lending market because their costs are based on the LIBOR rate.

- SBA has allowed a new structure for assembling SBA loans into pools for sale in the secondary market. According to SBA, the enhanced flexibility in loan pool structures can help affect profitability and liquidity in the secondary market for SBA-guaranteed loans. Because the average interest rate is used, these pools are easier for pool assemblers to create, thus providing incentives for more investors to bid on the loans.

- On November 24, 2008, the U.S. Department of the Treasury announced that it would allocate $20 billion to back the creation of a $200 billion Term Asset-Backed Securities Loan Facility (TALF) at the Federal Reserve Bank of New York. TALF will make loans to investors who purchase asset-backed securities made up of small business loans guaranteed by SBA,

[2]In fiscal year 2007, SBA started charging 7(a) lenders fees to cover the cost of on-site reviews. These fees are separate from the guarantee fee and annual servicing fees that lenders pay.

[3]SBA, *SBA Announces New Ways to Improve Small Business Access to Credit* (Nov. 13, 2008).

auto loans, student loans, or credit card loans. According to SBA, this will make it easier for lenders to sell the loans they make and use the proceeds of those sales to make new loans.

- Introduced on February 7, 2008, the Small Business Lending Stimulus Act of 2008 (S. 2612) proposed to reduce 7(a) loan fees and authorize appropriations to cover such fee reductions. Specifically, the bill proposed to reduce fees on loans of less than $150,000 from 2 percent to 1 percent, on loans between $150,000 and $700,000 from 3 percent to 2.5 percent, and on loans of over $700,000 from 3.5 percent to 3 percent.
- Introduced on November 19, 2008, the 10 Steps for a Main Street Economic Recovery Act (S. 3705) proposed several measures to protect and expand small business lending, including increasing the amount of financing available to businesses under the 7(a) program from $2 million to $3 million, temporarily reducing fees to defray the cost of borrowing for small businesses, and providing tax breaks to small businesses.

Appendix II: Objectives, Scope, and Methodology

In this report, we (1) describe SBA's criteria for determining that borrowers cannot obtain credit elsewhere and practices lenders employ to determine that borrowers cannot obtain credit elsewhere and (2) examine SBA's efforts to ensure that lenders are complying with the credit elsewhere provision.

To determine SBA's criteria for determining that borrowers cannot obtain credit elsewhere, we reviewed applicable statutes, regulations, and program guidance. For background on the 7(a) program and the credit elsewhere provision, we reviewed the legislative history of the 7(a) program, our previous reports, and studies of the program conducted by the SBA Inspector General and external organizations.[1] We also interviewed officials from SBA's Office of Financial Assistance on guidance provided to 7(a) lenders.

To determine the practices that lenders employ to meet the credit elsewhere requirement, we visited 7(a) lenders located in and around the following cities: Atlanta, Georgia; Chicago, Illinois; Houston, Texas; Los Angeles, California; New York City, New York; San Francisco, California; and Washington, D.C. During these site visits, we interviewed officials at 18 lenders and reviewed 238 of their approved 7(a) loan applications. We selected these lenders to obtain a variety in the types of 7(a) loans they made (preferred lender program [PLP] and SBAExpress loans) and the size of their SBA loan portfolios. We also considered geographic diversity. In addition, we interviewed representatives of the National Association of Government Guaranteed Lenders, the trade association for 7(a) lenders.

Using data obtained from SBA, we ranked 7(a) lenders in each of the selected cities from largest to smallest based on the number of active or

[1]This report cites findings from the Urban Institute, *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*, Final Report (January 2008). In general, we found that the authors of the study followed a reasonable methodology in their interviews with 23 banks, given their objectives, and that the study could be cited with some caveats. Although the Urban Institute attempted to interview a cross section of lenders, it could not guarantee that the sample was representative of all lenders. Specifically, because only 23 of the 73 lenders agreed to interviews, this raises the possibility that the other lenders would have given different responses.

outstanding 7(a) loans for each lender.[2] With the exception of Chicago and Washington, D.C., we contacted lenders in each city in descending order until we achieved our quota (at least three in each city).[3] (See table 4.) For purposes of this report, we considered small lenders to be those with 50 or fewer active or outstanding 7(a) loans. We made three attempts to contact a lender before moving on to the next lender on the list.

Table 4: Number and Size of Lenders Interviewed in Each Selected Location

City	Total number of lenders interviewed	Number of large lenders	Number of small lenders
Atlanta, Georgia	3	1	2
Chicago, Illinois	1	0	1
Houston, Texas	3	3	0
Los Angeles, California	4	4	0
New York City, New York	3	2	1
San Francisco, California	3	2	1
Washington, D.C.	1	1	0

Source: GAO.

The applications we reviewed generally covered loans that were approved within calendar years 2007 and 2008. The number of files we reviewed at each lender was based on the size of the lender's portfolio and GAO staff resources. On the basis of a pilot test at one lender, we determined that we could review approximately 20 files during one site visit. As a result, we reviewed between 5 and 25 of each lender's most recently approved loans, depending on the size of the lender.[4] To strengthen the accuracy of the

[2]We received data from SBA's Loan Accounting System (LAS) on all lenders that made one or more SBA loans during fiscal years 2005-2007. We previously performed testing on SBA's LAS and found the system and data to be reliable. See GAO-07-769, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance* (Washington, D.C.: July 13, 2007). In addition, we performed reliability testing on the data extraction we received from SBA, including testing the extraction for missing and incomplete data, and found the data to be reliable for purposes of selecting a sample of lenders to interview for this report.

[3]We conducted a pilot test of our data collection instrument with one lender in Washington, D.C. We attempted to contact and schedule interviews and file reviews with three lenders in Chicago; however, only one lender responded to our request.

[4]In only one case was the number of files requested not available. As a result, we reviewed fewer files at that lender than our methodology required.

collection of information from lender files, we validated our data entry for 20 percent of all files reviewed at each lender. The sample of lenders we visited was not designed to be generalizable to the population of 7(a) lenders, nor was the sample of loans at each lender designed to be generalizable to the population of 7(a) borrowers at each lender.

To assess SBA's efforts to ensure lender compliance with the credit elsewhere requirement, we reviewed excerpts from all 97 on-site lender review reports completed from October 1, 2006, through March 31, 2008. These excerpts documented SBA's assessment of the lenders' compliance with the credit elsewhere requirement and personal resources test. We also reviewed correspondence between SBA and the 31 lenders that had credit elsewhere or personal resources test findings. This correspondence detailed the corrective actions that the lenders had implemented or agreed to implement to address the identified deficiencies. We interviewed staff from SBA's Office of Credit Risk Management on their oversight of 7(a) lenders and the SBA contractor that performs the on-site reviews on steps taken during on-site reviews to assess compliance with the credit elsewhere requirement and personal resources test.

We conducted our work in Atlanta, Georgia; Chicago, Illinois; Houston, Texas; Los Angeles, California; New York City, New York; San Francisco, California; and Washington, D.C., between February 2008 and February 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix III: Implications of Imposing a More Prescriptive Credit Elsewhere Requirement

SBA could revise the implementing regulations and guidance for the 7(a) program to create a more prescriptive credit elsewhere requirement. For example, SBA could establish some general guidelines describing quantitative thresholds or ranges for cash flow and credit score that lenders could consider when making 7(a) loans.[1] The agency could require lenders who made loans to borrowers who fell outside of the recommended ranges to document the reasons for their decisions. Further, additional guidelines could help lenders determine when it was acceptable to cite reasons associated with the lending institution itself to substantiate that a borrower could not obtain credit elsewhere. In such a scenario, some of these reasons might apply only to certain institutions. For example, only nondepository institutions, such as small business lending companies (SBLC), might be allowed to cite as a reason for extending 7(a) credit the need to sell the guaranteed portion of the loan on the secondary market.

A more prescriptive credit elsewhere requirement would address some of the challenges with the requirement as it is currently written. For example, as previously discussed, a broad requirement allows lenders to make case-by-base decisions about the types of borrowers that cannot obtain credit elsewhere. Because different lenders have different lending policies, the types of borrowers they serve under the program also differ. The absence of well-defined eligibility criteria makes it difficult for SBA to determine whether borrowers receiving 7(a) loans actually could not obtain conventional credit. In addition, these variations in lending policies and the types of borrowers served make it challenging for SBA to collect relevant information for evaluations of how well the 7(a) program is serving its intended mission. In a July 2007 report on the 7(a) program, we highlighted the need for SBA to improve upon its current efforts to collect and evaluate performance data for the 7(a) program.[2] According to SBA, it is in the process of developing additional performance measures.

A more prescriptive standard could be beneficial in light of proposals that, if enacted, would reduce fees for borrowers and temporarily change the

[1] A personal credit score is generated by a mathematical formula using information from a credit report. Personal credit scores can range from 300 to 850. Lenders we spoke to do not consider any variable, such as credit score or debt service coverage ratio (DSCR), in isolation when making lending decisions. In fact, low credit scores or DSCRs may be compensated for with more valuable collateral or management experience, for example. Guidelines outlining quantitative or other thresholds would have to be flexible enough so as not to require lenders to make lending decisions based on one variable.

[2] GAO-07-769.

program from a zero subsidy program to a positive subsidy program.[3] Such proposals have been made for reasons such as expanding credit for small businesses during the current economic downturn. According to SBA and lenders interviewed as part of an Urban Institute report, the higher fees currently associated with the 7(a) program act as a credit-rationing mechanism.[4] They explained that the higher fees deter borrowers who could obtain credit elsewhere from participating in the program, as the fees associated with conventional loans are significantly lower. However, if the fees associated with the program were lowered or eliminated, the impact of this rationing mechanism would be reduced. With the reduction of fees, a more prescriptive credit elsewhere requirement that clearly outlines which businesses are eligible for the 7(a) program could help to minimize incentives for lenders to make loans to borrowers that have access to credit elsewhere.

However, the increased burden on lenders resulting from a more prescriptive credit elsewhere requirement could limit their participation in the program and, as a result, decrease small businesses' access to credit. In addition, a more prescriptive standard could arbitrarily exclude some borrowers from obtaining guaranteed credit but compel lenders to make loans to borrowers that they and the market did not deem creditworthy. Finally, restricting lenders' ability to cite their own reasons to substantiate that a borrower could not obtain conventional credit might limit access to credit in some communities, especially those with few lending institutions to supply credit or those that rely on SBLCs—nondepository institutions with delegated authority to make 7(a) loans.

[3]In fiscal year 2005, the 7(a) program became a zero subsidy program, which means it is entirely funded by user fees and does not receive an annual appropriation for new loan guarantees. However, the conference report accompanying the bill to eliminate program subsidies agreed to revisit the decision in the event of an economic downturn. See Conf. Rep. No. 108-792, *Making Appropriations for Foreign Operations, Export Financing, and Related Programs for the Fiscal Year Ending September 30, 2004, and for Other Purposes* (Nov. 20, 2004) (accompanying H.R. 4818, 108th Cong., 2nd Sess.) at 843. Introduced on February 7, 2008, the Small Business Lending Stimulus Act of 2008 (S. 2612) proposed to reduce 7(a) loan fees and authorize appropriations to cover such fee reductions. Specifically, the bill proposed to reduce fees on loans of less than $150,000 from 2 percent to 1 percent, on loans between $150,000 and $700,000 from 3 percent to 2.5 percent, and on loans of over $700,000 from 3.5 percent to 3 percent. Introduced on November 19, 2008, the 10 Steps for a Main Street Economic Recovery Act of 2008 (S. 3705) contained a provision that would temporarily reduce fees to defray the costs of borrowing for small businesses owners and SBA lenders. If enacted, the bill would reduce fees for the 7(a) program.

[4]See the Urban Institute, *An Analysis of the Factors Lenders Use to Ensure Their SBA Borrowers Meet the Credit Elsewhere Requirement*, Final Report (January 2008).

Appendix IV: Comments from the Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

February 3, 2009

Mr. William Shear
Director, Financial Markets and
Community Investment Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to comment on GAO's draft report---Small Business Administration: Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight.

We are very pleased to see that, in the draft report, GAO concludes that our oversight efforts are making a difference and helping lenders better understand and comply with the U.S. Small Business Administration's (SBA) policies.

SBA works to establish clear guidelines and standards that ensure documented lender compliance without creating overly burdensome paperwork. The Agency will work with its incoming Administrative leadership to use the findings presented by GAO to create more specific guidance for lenders around documenting compliance with credit elsewhere standards in a way that achieves this balance.

If you have any questions, please contact Tiffani Cooper, GAO Liaison at (202) 205-6702.

Sincerely,

for Eric R. Zarnikow
Associate Administrator
Office of Capital Access

Federal Recycling Program Printed on Recycled Paper

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition to the individual named above, Paige Smith (Assistant Director), Benjamin Bolitzer, Tania Calhoun, Marcia Carlsen, Emily Chalmers, Janet Fong, Marc Molino, Carl Ramirez, Cory Roman, and Jennifer Schwartz made contributions to this report.

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