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

OFFICE OF THE ADMINISTRATOR

October 14, 2008

The Honorable John Kerry
Chairman
Committee on Small Business
and Entrepreneurship
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your recent letters concerning the U.S. Small Business Administration's (SBA) October 2007 changes to the credit elsewhere test. I appreciate your offer to work together to ensure that the test is reasonable and I understand your concern for small businesses in Iowa and elsewhere in the Midwest. I have personally visited Iowa and met with small businesses and local officials, and I understand the obstacles they are experiencing in their efforts to recover.

As approved by Congress, the Small Business Act, Section 7(b), requires that borrowers who can obtain credit elsewhere receive disaster loan assistance at the higher rate and, in the case of businesses, a shorter term for repayment of their loan. The credit elsewhere test is the result of this statutory requirement. Our goal in administering the disaster loan program is to have a fair measure of whether or not a disaster loan applicant can obtain credit elsewhere.

In particular, I share your concern about small businesses that the agency may have deemed as having credit available elsewhere, but that have not been able to obtain credit at reasonable market rates in the private marketplace. For this reason, I have provided guidance to the field to clarify the applicability of the hardship waiver test. This notice will remind SBA loan officers to ensure business borrowers are reviewed to determine if the higher credit available elsewhere rate and limited term imposes undue financial hardship. For the 67 small businesses in Iowa who qualified for the higher credit available elsewhere rate, the Agency will immediately review the loan applications for these businesses to ensure the credit elsewhere test was properly applied and, where appropriate, whether or not a financial hardship waiver should be considered. In cases where SBA will be able to grant a financial hardship waiver, a new loan with a lower interest rate and longer terms will be offered to the small business.

I also appreciate the opportunity to clarify the data that has been misrepresented in several press accounts regarding SBA's disaster loans in Iowa. As of October 7, 2008, the Agency has approved 3,522 disaster loans totaling $237,651,500 in Iowa. Fully 71 percent of these SBA disaster loans, representing 87 percent of total loan dollars, are at the lower, credit not available elsewhere rate.

Specifically regarding businesses accessing SBA's disaster loan program in Iowa, 89 percent are at the lower, credit not available elsewhere rate. Eleven percent of business loan applicants (67 businesses), representing just 6 percent of business loan dollars, qualified for the higher, credit elsewhere rate. For these 67 businesses in a stronger financial position, a three-year loan term is mandated by law and not subject to change without legislation from Congress. As you point out in the questions included in your letter, several of these businesses have found better loan terms in the marketplace. This is evidence that supports the Agency's determination that those specific applicants do have the ability to secure credit elsewhere and by law, are eligible only for the higher credit elsewhere available rate.

As required by the law, SBA implements the credit elsewhere requirements to ensure the Federal Government is not displacing or competing with valid private sector options. SBA has not changed its position with regard to the need to examine the overall financial conditions of the borrower as a part of the credit elsewhere test. The percentage of applicants who qualify for the lower credit not available elsewhere interest rate will vary based on their financial solvency and their ability to meet the asset requirements. For homeowners in Iowa seeking assistance from SBA, 67 percent qualify for the lower credit not available elsewhere rate, leaving 33 percent of the homeowners who are eligible for the credit available elsewhere rate, which, at 5.375 percent is still below the market rate. Additionally, the loan terms provided by SBA are better than what the market would provide.

To address SBA's Office of Inspector General as well as internal policy concerns, SBA has adjusted the credit elsewhere test to incorporate standard market practices and mirror the approach used by most lenders in making credit decisions. In October 2007, these changes were incorporated into our Disaster Standard Operating Procedure (50 30 6), which is publicly available for review on SBA's website. This approach examines the applicant's cash flow to assess repayment ability, assets available to secure the loan, and, in the case of homeowners, the applicant's credit history. The test compares the applicant's net assets to the amount of uncompensated loss and the applicant's available cash flow to repay the loan at market rates. For example, under this test, a business applicant with an uncompensated loss of $2 million would have to have an adjusted net worth of more than $8 million to be determined to have credit available elsewhere. These improved standards ensure the test is a reasonable measure of an applicant's ability to obtain credit from non-Federal sources at reasonable terms and rates.

I fully understand your concerns on this issue. I believe that SBA's decision to re-examine the disaster loans to businesses made at the credit elsewhere rate will alleviate some of the concerns you have expressed. I hope you share my opinion that SBA has significantly improved its disaster operations and responsiveness. The turn-around times for loan processing have improved significantly, and the Agency is processing loans faster than our set goal. Our dedicated personnel in Iowa, many of whom opened our Disaster Recovery Centers within an hour of the Presidential Declaration in Iowa, are still on the ground providing assistance to businesses and homeowners as they recover from the floods. I have enclosed answers to your specific questions and hope this will satisfy your concerns. We will coordinate with your staff to address any additional requests you may have. I hope that we can continue to work together to ensure Iowans and Midwesterners receive the assistance they need to recover from these floods.

Sincerely,

Sandy K. Baruah
Acting Administrator

Enclosure

- Enclosure -

What prompted the change in the standard for credit elsewhere?

The SBA strives to help disaster victims while operating the disaster loan program in a fiscally responsible manner. Statute requires that the agency determine whether loan applicants can obtain "credit elsewhere" at reasonable rates and terms or have the resources to recover on their own.

In 2007, as part of the agency's continuing review of its Credit Elsewhere Test (CET), SBA made changes to reflect private sector processes and benchmarks. Loan applicants who can obtain credit elsewhere or who can recover on their own may still qualify for an SBA loan, but will receive rates and terms that are in line with the private market. This balanced approach considers both the concerns of the home or business owner and the taxpayers.

As part of the program review and in response to criticisms made by the SBA Inspector General, SBA questioned whether the then-current test fairly measured whether a borrower was able to obtain credit elsewhere. SBA determined that the primary reason for the low number of disaster loans made at the "credit available elsewhere" rate was largely due to the high thresholds set for the ratio of net assets or available net worth to uncompensated loss. For example, under the previous test, a homeowner or renter with an uncompensated loss of $200,000 would have had to have $2 million in net assets to be determined to have credit available elsewhere. A business owner with a $1.5 million uncompensated loss would need a net worth of $30 million or more for a similar determination.

In order to better align the credit elsewhere thresholds, the SBA changed the net assets to an uncompensated loss ratio of 4 to 1 for both home and businesses. Given the examples above, that homeowners would now be required to have net assets of $800,000 and that business owners would need to have $6.0 million in net assets for a determination that they are able to obtain credit elsewhere. This ratio, along with having a sufficient cash flow to service a loan at market rates and, in the case of homeowners, an excellent credit history is a reasonable measure of an applicant's ability to obtain credit elsewhere. The procedures also provide for a waiver of the credit elsewhere determination if the market rate causes an undue financial hardship upon the applicant. SBA is issuing guidance to the field to ensure that businesses that receive the higher, credit available elsewhere rate do not endure undue financial hardship, and is specifically taking a look at the businesses in Iowa who were qualified for the credit available elsewhere rate.

What was the Office of Management and Budgets role in changing the standard?

SBA shared its analysis with OMB as part of the budget making process that all agencies participate in. All changes to any of the SBA loan programs are routinely shared with OMB in an effort to comply with the requirements mandated by Congress in the Federal Credit Reform Act of 1992.

Why didn't the Administration consult with the Congress or give the public a chance to comment when making this change to an interpretation of a statutory requirement?

It has been SBA's decades-long practice to update the Agency's Standard Operating Procedures when any programmatic changes occur. This is necessary because the program must be able to change and adapt quickly in response to disaster situations. The guidelines for the Disaster program are apparent and publicly available, including the details of the Credit Elsewhere Test set forth in SOP 50 30, which can be found on the SBA's website at http://www.sba.gov/tools/resourcelibrary/sops/index.html.

Please provide a series of examples as to what percentage of homeowners or business owners received loans at the market rate and below-market rate for several disasters both before and after the change in the rule?

FY 2007	
Declaration	**% at CE rate**
HI-00005	20
NY-00036	10
NY-00045	25
NJ-00006	17
KS-00018	10
SD-00012	25
TX-00254	15
KS-00022	9
MN-00011	20

FY 2008	
Declaration	**% at CE rate**
WI-00013	51
IA-00015	30
IN-00019	30
IL-00015	37
MO-00030	32
NE-00020	47
LA-00019	28
TX-00297	34
FL-00035	48

*Note – Given differences in damage incurred, credit available and other factors, these figures should not be considered comparative.

There have been reports that individuals have found lower interest loans from the private sector. If SBA is supposed to offer a rate of 8 percent or the market rate, whichever is lower, why are individuals finding superior rates in the private sector?

The Small Business Act, Section 7(d) 4 provides that applicants determined to have the ability to obtain credit elsewhere be charged a rate not to exceed 8 percent. We do not match the individual rates that a single borrower can get. We must set our rate based on the "prevailing market rate," as deemed by statute.

Individuals who have the ability to obtain credit elsewhere and have an excellent credit rating may be able to obtain better rates in the commercial market. This supports the Agency's determination that the applicant does have the ability to obtain credit elsewhere and, by law, is only eligible for the higher credit available elsewhere disaster loan rate.

The real help on the ground does not come until the money is in the hands of people so they can begin to rebuild. There have also been reports of extensive delays in the Midwest in disbursing payments for approved loans. While SBA has worked to improve the time period for processing and approving loans, can you share any information about the time delays between approval and disbursement? Also, how do these delays compare to delays after previous disasters of similar magnitude?

The SBA is not aware of any delays in the Midwest in disbursing funds for approved loans. Of the loans that have been closed, over 53 percent were fully disbursed within just a few months of the disaster being declared. Initial disbursements of up to $14,000 were made within five days on 99.9 percent of all loans. In fact, SBA has made disbursements on 81 percent of the loans that have been closed. The closing and disbursement process is primarily driven by the terms and conditions of the loan and the borrower's need for funds as rebuilding occurs. SBA case managers assist borrowers in this process to ensure that funds are disbursed when needed, generally within 3 to 5 days after they are requested.

Some loan applicants have reported that SBA is directing them as to how to rebuild their businesses. Why is this necessary? Does the SBA make disaster assistance contingent upon these recommendations?

SBA does not tell borrowers how to rebuild. The Small Business Act provides guidance and terms for the use of disaster funds, which borrowers must follow. When SBA approves each loan application, it issues a loan authorization which specifies the amount of the loan, repayment terms, any collateral requirements, and the permitted use of loan proceeds. This ensures that the proceeds of the loan are used for the intended purpose and the loan is properly secured, which is SBA's fiduciary responsibility to the American Taxpayer. The loan documents provide the pertinent conditions that borrowers must comply with, including that the funds may only be used for specified purposes. The clarity and specificity of these conditions are meant to help borrowers avoid being subjected to criminal and civil penalties that could result from the misuse of funds.