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

TESTIMONY OF
ADMINISTRATOR KAREN G. MILLS

BEFORE THE
HOUSE COMMITTEE ON SMALL BUSINESS
JUNE 6, 2012

Chairman Graves, Ranking Member Velázquez and members of the Committee – thank you for inviting me to testify on the SBA's lender oversight program.

As I have said in previous testimony before the Committee, this Administration takes a "zero tolerance" stance on fraud, waste, and abuse in each of our programs, including our 7(a) and 504 loan programs. In the wake of the financial crisis and corresponding downturn in the general economy, this Administration has brought a new intensity to how we approach lender oversight.

Over the past three years, we have engaged in an extensive review and redesign of SBA's lender oversight activities. This has led to several changes to our lender oversight program, including enhanced supervision and more aggressive enforcement against problem lenders, loan agents, brokers and packagers, and loan applicants.

Much of the progress we have made in our oversight efforts has been accomplished through improved collaboration and communication with our Office of Inspector General (OIG), which is led by Peg Gustafson. One of the many things Peg and I identified early on is the importance of a strong "oversight culture" at SBA and the implementation of best practices used by other agencies and financial institutions. I also should note that many changes we have implemented are in line with recommendations made by the OIG and the Government Accountability Office (GAO), as well as members of this Committee.[1]

Key Drivers of Lender Oversight Changes

To begin this process of revamping our lender oversight, we commissioned a third-party study to assess our processes, organizational structure, and our risk analytics. In addition, we engaged our sister agencies that conduct lender oversight programs of their own—including the Farm Credit Administration (FCA), the Export-Import Bank (Ex-Im), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (Fed), and the Office of the Comptroller of the Currency (OCC). These agencies are sharing with us their best practices on a number of oversight topics, including the importance of establishing a comprehensive risk plan for the Agency, which identifies the factors the organization will consider in evaluating acceptable risk parameters for the SBA portfolio and the lenders that underwrite SBA loans. SBA expects to complete its first comprehensive risk plan before the beginning of the next fiscal year and will issue updated plans annually thereafter.

[1] SBA has closed 80 OIG recommendations spanning 25 audit reports, and SBA believes the changes being made within OCRM will help close several more.

Finally, over the past several months, we have listened to feedback from our lending partners. In general, they have asked us for greater clarity, consistency, and transparency in a number of lender oversight areas. We are incorporating this feedback into our lender oversight program.

The study findings, best practice sharing, stakeholder feedback, and our own internal analysis are driving the changes we are making in our Office of Credit Risk Management (OCRM). The focal points of these changes fall into four key areas: (1) organizational changes within OCRM; (2) process improvements to our Risk Based Reviews (RBRs)—the periodic assessments of an SBA lender's management operations and controls; (3) improving OCRM's risk analytics—the methods we use to assess the risk that a loan or lender poses to our portfolio; and (4) more robust Agency supervisory and enforcement mechanisms.

Organizational Changes

In terms of organizational changes, earlier this year we brought on a new OCRM director, who brings a wealth of experience monitoring lenders—both large and small. He served eight years with the FCA, and more recently he spent six years at the FDIC. He has already met with Congressional staff several times to share his insights and obtain feedback, and we would certainly welcome and appreciate any additional guidance you or your staff may have on the topics we are discussing today.

In addition to management changes, we are taking steps to realign OCRM's structure to reflect our increased emphasis on enforcement, transparency and accountability. This is highlighted by important shifts in how oversight will be conducted—both geographically and institutionally. OCRM will adopt a regional approach to supervision, which is used by the FDIC and OCC. This will allow for more precise assessment of banking and business lending activity by economic region, much like that of the Fed. This new structure will be complemented by a shift toward tailored RBRs for each of our three primary lender groups: 7(a) depositary lenders, Certified Development Companies (CDCs), and 7(a) non-depository lenders. This realignment will allow us to move away from the previous "one-size-fits-all" approach to our portfolio and the lenders that comprise it, and puts us more in line with industry best practices.

Following a recommendation in the third party study, we are also in the process of creating a quality and standards unit to, among other things, develop lender and loan benchmark metrics. This new unit will help anticipate and identify problems before they occur.

Changes to Risk Based Reviews

Many of our lenders recommended that our RBRs should be redesigned for more targeted portfolio assessment. Our shift towards institutional tailoring addresses these concerns.

Also, in the past, OCRM placed heavy emphasis on lender characteristics such as the size of the SBA portfolio. However, recent data, trends and best practices indicate that lender behavior triggers are also significant in determining our monitoring activities. As a result, our new risk-based portfolio approach will also include critical lender behavior factors, such as high loan volume growth and a lender's secondary market exposure. We have received a positive response to these proposed changes from the SBA lending community.

Improvements to SBA's Risk Analytics

The third party study, as well as our internal analysis, found that while the data we collect through a variety of sources is robust, there are more effective ways to use this data. As a result, we are working to enhance OCRM's processes and platforms in order to better leverage our data.

For example, we determined that SBA's risk data warehouse should be oriented toward one unified data portal for consolidated lender information. This means leveraging the portfolio data by sharing it with the proper offices and individuals to ensure consistency across the board in our loan programs. This not only improves our ability to properly manage risk, it also provides our lending partners with greater clarity as they monitor their own SBA portfolios.

OCRM also will be expanding the use of data analysis in determining which SBA lenders will be required to undergo an RBR. By making our RBRs more targeted, we will optimize the staff and budget resources needed to perform the reviews.

We are also engaged in ongoing discussions with the FDIC, OCC and the Fed to improve our data sharing capabilities. This will help us avoid unnecessary duplication and improve the effectiveness of our portfolio monitoring efforts.

And finally, the lender risk rating model we developed in cooperation with Dun & Bradstreet is being reviewed and updated. This effort was guided in part by the findings of a GAO report, which found that our risk rating information was adequate, but the way OCRM utilized the data required strengthening.

Higher Intensity Oversight and Enforcement

The fourth area of emphasis involves more robust enforcement of SBA's lending requirements, including more timely corrective actions and, where appropriate, the non-renewal or revocation of a lender's SBA loan authority. This has been the topic of several OIG recommendations, and it is an area where we are taking aggressive action as part of the enhanced collaboration between the OIG and our Office of General Counsel (OGC). These actions are focused on overseeing lenders and CDCs that exhibit increased risk behaviors like a downgrade in the lender's "risk rating," higher risk portfolios, or repeated non-reporting and errors. These behaviors, in turn, may lead to enhanced SBA supervision and enforcement actions.

Over the past three fiscal years, we have declined to renew delegated lending authority 347 times for SBA 7(a) lenders and 7 times for CDCs in our Accredited Lenders Program where these entities did not meet SBA loan program requirements. Working closely with the OIG and our OGC, we will continue to aggressively pursue problem lenders and actors. For example, since FY 2009, we have suspended or debarred over 50 loan officers, loan brokers, packagers, and applicants in the 7(a) program.

And we are continuing to ramp up our oversight and enforcement activity: First, by creating an enforcement unit—the Lending Supervision and Enforcement Task Force (LSETF)—which is a partnership between OCRM and our OGC to develop and propose enhanced supervision and enforcement recommendations; and second, by bringing, as appropriate, such recommendations to the Lender Oversight Committee (LOC) for consideration and action.

The LOC provides independent oversight for supervision and enforcement efforts undertaken by OCRM. It is chaired by SBA's Chief Operating Office and has two other voting members, our Chief Financial Officer and our Associate Administrator for Capital Access. The LOC also includes several senior Agency managers, who are non-voting members.

Goals and Challenges

The goals of our oversight changes are twofold: ensuring that our loans benefit only the small businesses for which the lending programs are intended, and protecting the taxpayer dollars that support our loan programs. We believe we now have the tools and structures in place to more effectively achieve both goals. But there are some obstacles that we must overcome.

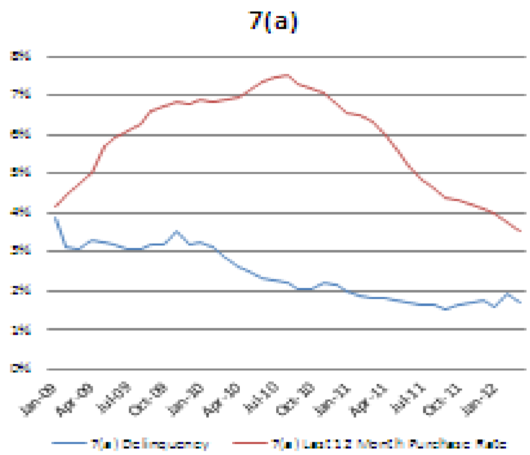
One challenge we are currently facing in our effort to improve our lender oversight program is the "stratification" of our current portfolio. Like the private banking industry, SBA organizes its loan portfolio into cohorts. Generally, SBA divides these cohorts into two broad portfolio categories separated by the recession: the legacy portfolio—loans made before 2009—and our emerging portfolio, which is comprised of loans made after the depths of the recession in 2008. We are finding that our legacy portfolio presents different risks than our emerging portfolio.

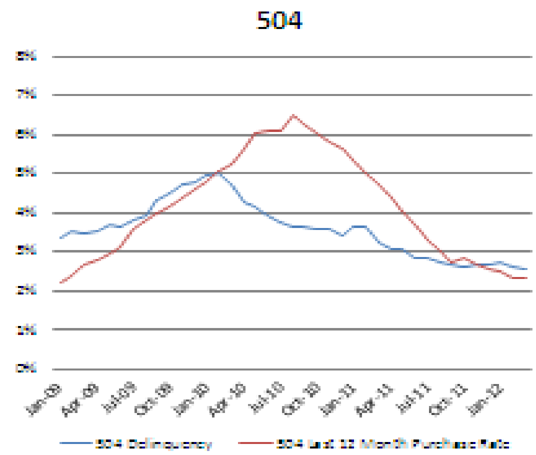
Most notably, the legacy portfolio includes loans made before the financial crisis and the real estate bubble, giving them higher risk characteristics. Essentially, the higher default rates in the 7(a) and 504 programs over the past few years were largely generated by the 2005, 2006, 2007, and 2008 cohorts. Therefore, the legacy portfolio will require greater attention in terms of servicing.

To minimize the impact on taxpayers and reduce costs, we have taken several steps to improve the liquidation and recovery process to ensure that we recoup all or at least a significant portion of the amount owed on loans in the legacy portfolio. For instance, we recently improved the way that 7(a) lenders and CDCs report their non-performing loans. This will assist us in identifying loans that are recoverable by lenders and SBA. We have also been working with the Department of Treasury to refer responsible parties for "cross servicing," which allows us access to Treasury collection tools like wage garnishment and administrative offset programs under the Debt Collection Improvement Act of 1996.

The graph set forth on the following page illustrates the current status of the default rates in the SBA 7(a) and 504 portfolios. It shows delinquency and purchase rates (defaults) are declining for the portfolio after peaking in July of 2010. This decline is due in large part to the strength of the underwriting for our emerging portfolio.

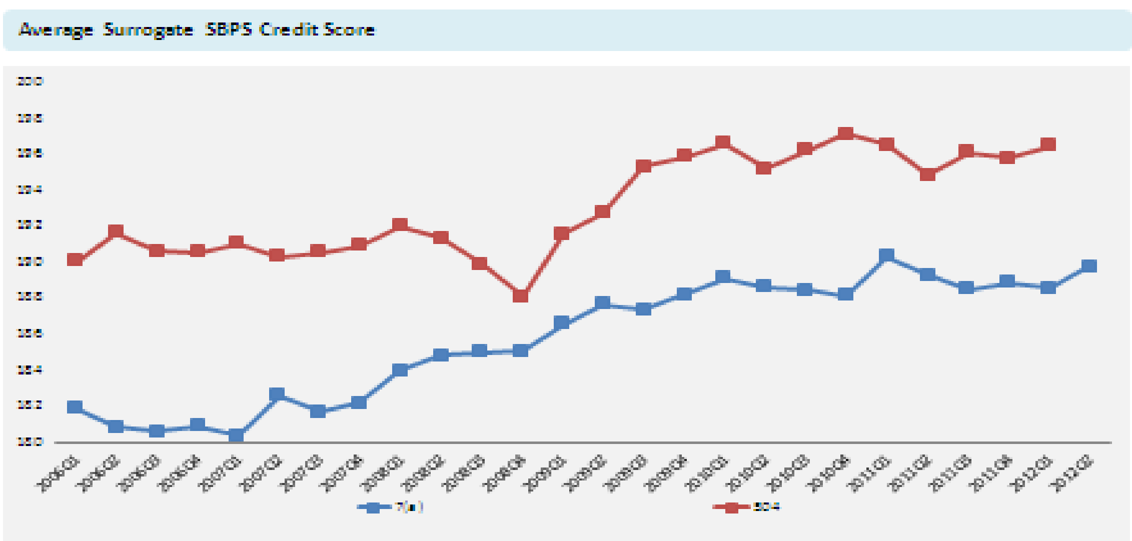
After peaking in the final quarter of FY 2010, SBA delinquency and purchase rates have steadily declined to pre-recession levels.





The characteristics of our emerging portfolio are strong, with an improving credit quality, as shown in the graph below.

The credit quality of SBA loans has risen steadily over the past three fiscal years, creating a strong "emerging portfolio" of loans.



*SBPS is a blended personal and business credit score provided by FICO and Dun & Bradstreet, and is on a range of 0-300.
**Data reflects the credit score reported by the SBA lender within three months of the loan's disbursement.

As we worked to increase access to capital to more communities over the past few years, we have added many new lenders to the program. Consequently, we need to evaluate and closely monitor the portfolio of these lenders, who are new to SBA programs, to ensure they comply with applicable rules and reporting requirements.

The 3-Pronged Approach

These areas of focus described in my testimony comport with our Agency-wide approach to preventing fraud, waste, and abuse—what we call our "3-pronged" approach to risk. SBA has enhanced lender oversight by (1) providing greater focus on preventing fraud or abuse before it happens, (2) continual monitoring of loans in the SBA portfolio, and (3) strengthening our enforcement function by punishing bad actors, whether they are lenders, loan agents or borrowers.

As you may know, we successfully used this model to create a more efficient and robust contracting oversight program at the SBA. Our efforts in implementing the 3-pronged approach resulted in unprecedented actions taken against big businesses that were masquerading as small ones to land government contracts reserved for small firms.[2]

SBA has made significant progress in all three areas of our 3-pronged approach. We are now using the best practices developed through reforms in our government contracting program to bolster oversight of our loan portfolio. In addition to the improvements described earlier in my testimony, there is progress in other areas that tracks the 3-pronged approach.

Like the government contracting changes, our lender oversight improvements begin with enhanced up-front screening for SBA loans and lenders. On the individual loan side, this means making better use of the SBPS—or Small Business Predictive Score—information transmitted on each SBA loan. And on the SBA lender side, we are analyzing the lender risk rating model elements to bolster the credibility and confidence in determining qualification requirements for Small Business Lending Company (SBLC) licensing and CDC authority. At the same time we are making progress in terms of efficiency. For example, we have moved the RBR turnaround time from six months to 30 days, and we have intensified corrective action monitoring to within 60 days.

In the monitoring category—the second prong—our capabilities have improved real time portfolio monitoring to identify "red flag" loans and lenders. Once identified, these red flags are followed by more in-depth "desk reviews" of SBA loan portfolios with high-risk characteristics. Where necessary, these desk reviews will trigger comprehensive on-site reviews for lenders that engage in excessive risk taking.

And finally, as I mentioned previously, we intensified the actions taken against lenders that exhibited unacceptable risk behaviors or did not comply with SBA rules and requirements. For these higher risk lenders, the LSETF is overseeing enhanced supervision or enforcement actions as appropriate. Finally, SBA has stepped up its efforts to root out loan officers, agents, brokers,

[2] The SBA has taken 71 contracting enforcement actions since 2009. In FY 2012, SBA has supported an additional 24 contracting enforcement actions taken by other governmental agencies.

and packagers who fail to comply with our lending standards and processes or defraud the government.

Using the 3-pronged approach, we believe we now have the tools in place to sustain the improvements we have seen in the credit quality of more recent loans, to effectively manage our legacy portfolio, and to provide robust and timely enhanced supervision or enforcement of SBA lending policies in the coming years. The progress has been significant, and we look forward to building on it as we move forward.

SBIC Oversight Framework

I would also like to take the opportunity to discuss the oversight activities of another SBA program—the Small Business Investment Company (SBIC) program, which is housed within our Office of Investment. The office has taken three key actions to improve its SBIC oversight operations: (1) performed quantitative analysis; (2) improved data collection for SBICs; and (3) expanded the office's oversight tools. These steps have ensured strong oversight while helping to increase the number of small business investments made through our SBIC program.

In conducting quantitative analysis of the SBIC program, we hired a third party to examine the performance of our SBICs and the key characteristics that contributed to their performance. The goal was to identify those characteristics that might signal increased risks to the SBIC portfolio and improve how SBA mitigates against such risks. For instance, the analysis showed that funds with lower levels of private capital (e.g., $5 to $10 million), generally experienced higher loss rates. As a result of this finding, we increased scrutiny of those SBIC funds with $10 million or less in private capital.

Our Office of Investment also took a close look at SBA's financial reporting requirements for SBICs. As a result, we expanded the requirements to include improved portfolio company financial information and overall investment performance. This improved data collection reflects best practices suggested by the Private Equity Industry Guidelines Group and will allow SBA to more quickly and effectively identify potential problems.

The final action we took in strengthening our SBIC oversight infrastructure was to expand the risk management tools available to our analysts. For example, the Office of Investment is expanding its Web-based reporting capabilities, which will improve the quality of the data our analysts use to evaluate existing and prospective SBIC funds.

As you can see, over the past three years we have increased oversight intensity in our loan programs and in the SBIC program. Our goal continues to be to get needed capital into the hands of deserving small businesses and entrepreneurs, while being effective stewards of taxpayer dollars.

We view lender oversight as an area for ongoing improvement and are committed to sustaining and building on our recent progress. In doing so, we will continue to seek out industry best practices and feedback from members of this Committee and our small business stakeholders. We look forward to an ongoing dialogue and welcome the opportunity to work closely with you as we further strengthen and improve our lending programs.

Thank you once again for the opportunity to testify before you on this important topic, and I am happy to take your questions.