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Report to Sen. Gaylord Nelson, Chairman, Senate Select Committee on Small Business; by Elmer B. Staats, Comptroller General.

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Under the 7(a) loan program, the Small Business Administration (SBA) makes or guarantees loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital. The feasibility of transferring responsibility for approving, servicing, and liquidating 7(a) guaranteed loans from the SBA to the private lenders participating in the program is being investigated by the Congress. Findings/Conclusions: There was no consensus among the private lenders interviewed concerning the feasibility of transferring more 7(a) responsibilities to private lenders. Concerns expressed by officials of private lending institutions, the SBA, or the American Bankers Association regarding transferring 7(a) loan responsibilities to private lenders included: (1) current legislation does not permit SBA to delegate responsibility for committing Federal funds to private lenders; (2) there is a potential for abuse and conflict of interest in permitting private lenders to make decisions on loans guaranteed by the Federal Government; (3) eligibility requirements of the 7(a) loan program change frequently; (4) the Federal Government may lose its priority in bankruptcy proceedings if nongovernmental agencies conduct liquidations; (5) private lender personnel are changing constantly and are unable to develop expertise in the 7(a) program; and (6) there may be increased adminstrative burden and cost to private lenders because of additional responsibilities. (Author/SC)

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RELEASED 5/4/78

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Should Lenders Assume More Responsibility In The Small Business Administration 7 (a) Loan Program?

Under the 7(a) loan program, the Small Business Administration makes or guarantees loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital.

The Senate Select Committee on Small Business asked GAO's assistance in determining the feasibility of shifting more responsibility for approving, servicing, and liquidating 7(a) loans from the Agency to private lenders.

This report reviews and compares the division of responsibility between private lenders and Federal and State agencies for selected loan programs and presents the views of the Agency and private lending institutions on whether private lenders should be delegated these responsibilities.

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UNITED STATES GENERAL ACCOUNTING OFFICE

CED-78-88

APRIL 4, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114835

The Honorable Gaylord Nelson
Chairman, Select Committee on
Small Business
United States Senate

Dear Mr. Chairman:

This report--the second in a series pursuant to your July 14, 1977, request--presents information to assist the Committee in evaluating the feasibility of transferring responsibility for approving, servicing, and liquidating 7(a) guaranteed loans from the Small Business Administration to the private lenders participating in the program.

It compares the loan approval, servicing, and liquidation responsibilities of private lenders and the Small Business Administration in the 7(a) loan program with those of private lenders and administering agencies in other Federal guaranteed loan programs and the Wisconsin State veterans mortgage lending program. Also presented are the views and opinions of officials from the Small Business Administration, private lending institutions, the Independent Bankers Association of America, and the American Bankers Association concerning the transfer of responsibilities. Details on our work are discussed in appendix I.

The other Federal programs reviewed were the emergency livestock and the business and industrial loan programs administered by the Farmers Home Administration, Department of Agriculture; the loan guaranty and insurance program administered by the Bureau of Indian Affairs, Department of the Interior; the business development loan program administered by the Economic Development Administration, Department of Commerce; and the housing loan program administered by the Veterans Administration. As you requested, we also reviewed the primary mortgage loan program administered by the Wisconsin State Department of Veterans Affairs. A description of the nature and purpose of these programs is included in appendix II.

In the 7(a) loan program, private lenders have initial responsibility for reviewing the loan applications and the Small Business Administration has primary responsibility for determining borrowers' credit worthiness and eligibility and for approving the loan. Private lenders have primary responsibility for servicing the loans, but the Small Business Administration has the ultimate responsibility for insuring that the loans are properly serviced by the lenders and for monitoring the borrowers' progress. The Small Business Administration has responsibility for deciding when delinquent loans will be liquidated and whether the agency or the lender will conduct the liquidation. The majority of loan liquidations are handled by the Small Business Administration.

With the exception of the Veterans Administration and the Bureau of Indian Affairs programs, the responsibilities of the private lender and the administering agency in each program reviewed are essentially the same as those of the private lender and the Small Business Administration in the 7(a) program. The Veterans Administration has given certain lenders the authority to approve guaranteed housing loans without prior agency review and concurrence. The Bureau of Indian Affairs gives lenders the option to liquidate defaulted loans without prior approval from the Bureau.

The Veterans Administration housing program is unlike the Federal business loan programs reviewed in that this program provides loans for the purchase of residential property. Also, the housing program guarantee is limited to 60 percent, up to a maximum of $17,500, while the business loan programs guarantee up to 90 percent of the loan.

There was no consensus among the private lenders interviewed concerning the feasibility of transferring more 7(a) loan approval, servicing, and liquidation responsibilities to private lenders. The Independent Bankers Association, for example, reported that it had found a genuine willingness within the association for its member banks to assume greater responsibility for approving, servicing, and liquidating these loans. (See app. III.) The American Bankers Association, on the other hand, expressed reservations concerning a shift in 7(a) loan responsibilities to lenders. (See app. IV.) However, some of the benefits cited by the officials interviewed that would result from transferring more responsibilities to the private lenders include more timely loan approvals, greater flexibility in loan servicing actions, reduction of excessive paperwork, speedier loan liquidations, and freeing of Small Business Administration personnel for other activities.

The following concerns were expressed by officials of private lending insitutions, the Small Business Administration, or the American Bankers Association regarding transferring 7(a) loan responsibilities to private lenders.

--Under the current provisions of the Small Business Act, the Small Business Administration cannot delegate responsibility for committing Federal funds to private lenders.

--There is a potential for abuse and conflict of interest in permitting private lenders to make decisions on loans guaranteed by the Federal Government.

--Eligibility requirements of the 7(a) loan program change frequently and private lenders are unable to keep up with the current regulations.

--The Federal Government may lose its priority in bankruptcy proceedings if nongovernmental agencies conduct liquidations.

--Private lender personnel are changing constantly and are unable to develop expertise in the 7(a) program.

--There may be increased administrative burden and cost to private lenders because of additional responsibilities.

In September 1976 the Small Business Administration began a test of an accelerated bank guaranty program designed to make 7(a) guaranteed loans available to small businesses in a faster time frame than was being experienced under the regular 7(a) guarantee program. The program test, which was terminated in March 1977, was unsuccessful because the credit criteria established by the Small Business Administration for the program were too stringent for the average 7(a) loan applicant to meet. According to the Small Business Administration, applicants meeting the new credit criteria were able to obtain loans without a guarantee.

The Small Business Administration has established a task force to determine whether additional 7(a) [illegible] approval, servicing, and liquidation responsibilit[illegible] can be transferred to private lenders. The task force suggestions have been incorporated into a proposed program under which lenders would be certified and delegated responsibility for evaluating loan applications and for recommending loan approvals to the Small Business Administration. The Small Business Administration would rely on the certified lender's recommendations and would approve recommended loans without further review. The lenders would also be authorized to make certain servicing decisions without prior concurrence from the Small Business Administration and to liquidate loans. A test of the task force proposed program is planned for July 1978.

Although this report does not evaluate the effectiveness of the 7(a) loan program, our report to the Congress of February 23, 1976, "The Small Business Administration Needs to Improve Its 7(a) Loan Program" provided an indepth analysis of the problems impacting the effectiveness of the 7(a) program and may be a source of valuable information to the Committee in considering changes in the 7(a) program. A copy of the digest of this report is contained in appendix V.

In order to expedite the report, we did not ask for formal comments from officials of the Small Business Administration. Also, this report will be released 30 days after the issuance date unless you publicly release its contents prior to this time.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

Contents

APPENDIX

ABBREVIATIONS

ABA	American Bankers Association
ACE	Active Corps of Executives
BIA	Bureau of Indian Affairs
DVA	Department of Veterans Affairs (Wisconsin)
EDA	Economic Development Administration
FmHA	Farmers Home Administration
IBA	Independent Bankers Association of America
SBA	Small Business Administration
SCORE	Service Corps of Retired Executives
VA	Veterans Administration

INFORMATION ON LOAN PROGRAMS REVIEWED AND OPINIONS ON GREATER LENDER PARTICIPATION IN THE 7(a) LOAN PROGRAM

On July 14, 1977, the Chairman of the Senate Select Committee on Small Business requested that we provide the Committee with information to evaluate the feasibility of transferring to private lenders more responsibility for approving, servicing, and liquidating 7(a) loans. The Chairman requested that we review other Federal guaranteed loan programs and the Wisconsin State veterans mortgage lending program to see how the responsibility for loan approval, servicing, and liquidation is divided between the government and private lenders and how the division of responsibility compare to that of the private lenders and the Small Business Administration (SBA) in the 7(a) loan program. The Chairman also stated that we should consider contacting private lenders for their views on private lenders assuming greater responsibility in the 7(a) loan program.

SBA 7(a) BUSINESS LOAN PROGRAM

A major SBA responsibility is administering the business loan program authorized by section 7(a) of the Small Business Act, as amended (15 U.S.C. 636(a)). Under this program, SBA makes or guarantees loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital. To be eligible for a 7(a) loan, a firm must be independently owned and operated and meet the small business size standard established by SBA for the firm's industry, usually expressed in terms of the number of employees or annual sales receipts. Certain types of small business, such as those engaged in speculative ventures or those that earn a portion of their annual income from gambling activities, are not eligible for a 7(a) loan.

Three types of loans are made under the 7(a) program-guaranteed, immediate participation, and direct. A guaranteed loan is made by a private lending institution with SBA agreeing to pay up to 90 percent of the loan, up to a maximum of $500,000, in the event of borrower default. The interest rate on guaranteed loans is established by the private lender subject to a maximum rate established by SBA. An immediate participation loan is made by either SBA or the private lending institution, with the other party purchasing an agreed upon percentage of the loan upon disbursement. SBA's share of an immediate participation loan generally cannot exceed 75 percent of the loan amount. A direct loan is made by SBA with no participation by a private lending institution.

Under the terms of the Small Business Act, SBA may not make an immediate participation loan unless a guaranteed loan is not available and may not make a direct loan unless an immediate participation loan is not available. The maturity of 7(a) loans may not exceed 10 years, except for that portion of a loan made to acquire real property or construct facilities, in which case the loan may have a maturity of 20 years.

Guaranteed loans account for the majority of loans made under the 7(a) loan program. Statistics provided by SBA show that as of December 31, 1977, SBA had approved 93,930 7(a) loans totaling about $6.4 billion. Of these loans, 79,688 totaling about $5.9 billion were guaranteed loans.

PROGRAM ADMINISTRATION

SBA administers the 7(a) loan program through a national headquarters office, 10 regional offices, and a series of district offices. The national office is responsible for developing and recommending agencywide program policies, reviewing and evaluating program effectiveness, and providing technical direction to the regional offices. The regional offices provide technical guidance to the district offices, supervise district office operations, evaluate district office performance, and review requests for reconsideration of loan applications.

The district offices, each headed by a director and under the jurisdiction of the regional offices, are responsible for the day-to-day operations of the 7(a) program. Within the district office, the

--financing division is responsible for reviewing loan application packages and recommending loan application approval or disapproval;

--portfolio management division is responsible for servicing loans, referring loans to the management assistance division, and representing SBA at foreclosure;

--management assistance division is responsible for providing management assistance to loan applicants and borrowers through the division's own resources or arranging for such assistance through the professional expertise of the Service Corps of Retired Executives (SCORE), the Active Corps of Executives (ACE), the Small Business Institute, a consultant contractor, or others.

SCOPE OF REVIEW

We compared the loan approval, servicing, and liquidation responsibilities of private lenders and SBA under the 7(a) program with those of private lenders and administering agencies for the following programs.

--The emergency livestock and the business and industrial loan programs administered by the Farmers Home Administration (FmHA), Department of Agriculture.

--The loan guaranty and insurance program administered by the Bureau of Indian Affairs (BIA), Department of the Interior.

--The business development loan program administered by the Economic Development Administration (EDA), Department of Commerce.

--The housing loan program administered by the Veterans Administration (VA).

--The primary mortgage loan program administered by the Wisconsin State Department of Veterans Affairs.

The Federal programs selected were based on our review of the Catalog of Federal Domestic Assistance and our discussions with officials of the Office of Management and Budget and the Department of the Treasury, and with staff of the Senate Select Committee on Small Business. We reviewed the loan procedures for each program and program and discussed the procedural and operational aspects of each program with headquarters and field office officials of each agency. Our work was performed at the following locations:

--SBA headquarters, Washington, D.C., and its Washington, D.C., New York City, and Dallas district offices.

--FmHA headquarters, Washington, D.C., and its Texas State office.

--EDA headquarters, Washington, D.C., and its regional office in Philadelphia, Pennsylvania.

--VA headquarters, Washington, D.C., and its regional offices in Muskogee, Oklahoma; Waco, Texas; and Washington, D.C.

--BIA headquarters, Washington, D.C., and its area office in Muskogee, Oklahoma.

--Wisconsin State Department of Veterans Affairs in Madison, Wisconsin.

We also obtained the views of officials of eight lending institutions participating in the 7(a) program, the Independent Bankers Association of America (IBA), and the American Bankers Association (ABA) on private lenders assuming greater responsibility for 7(a) loans. IBA membership consists of over 7,300 banks located primarily in small communities in 41 States and the ABA represents about 13,600 banks, or about 93 percent of the banks in the United States. We also interviewed officials of four lending institutions which participate in the other programs reviewed. The lenders interviewed were located in urban and rural areas in the States of New York, Oklahoma, Texas, Wisconsin, and in Washington, D.C.

Detailed descriptions of the programs reviewed other than the 7(a) program are included in appendix II.

DIVISION OF RESPONSIBILITY UNDER THE 7(a) LOAN PROGRAM

In the 7(a) loan program, private lenders have initial responsibility for reviewing the loan applications. SBA has primary responsibility for determining the borrowers' creditworthiness and eligibility and for approving the loan. Private lenders have primary responsibility for servicing the loans, but SBA has the ultimate responsibility for insuring that the loans are properly serviced by the lenders and for monitoring the borrowers' progress. SBA has responsibility for deciding when delinquent loans will be liquidated and whether the agency or the lender will conduct the liquidation. The majority of loan liquidations are handled by SBA.

Specific functions performed by the private lenders and SBA under the 7(a) loan program are discussed below.

Private lender loan processing functions

The law requires that SBA cannot make a 7(a) guaranteed loan if the needed funds are available from a bank or other private source. The private lender is responsible for analyzing each 7(a) guaranteed loan application and certifying to SBA that the lender would not make the loan without an SBA guarantee.

Firms applying for a 7(a) loan are required to provide the private lender with a completed loan application and other supporting documentation which includes information on the applicant's business history, existing debt, and abilities of management personnel; financial statements for the past 3 years and, if a new business, future earning projections; personal financial statements; description of the collateral pledged to secure the loan; details of pending litigation by and against the applicant; and a list of the applicant's subsidiaries and affiliates.

Upon completing the review of the loan application, SBA requires the lender to forward the application and supporting documents to the SBA district office servicing the area. Required to be included in the application package are (1) the lender's certification that credit is not available elsewhere at reasonable terms and that the lender will not make the loan without the SBA guarantee and (2) the lender's evaluation of the benefits of the loan, the applicant's ability to repay the loan, the adequacy of the collateral securing the loan, and the lender's comments on other pertinent loan information.

The private lenders we interviewed did not specify the type of analyses they performed on 7(a) loan applications. They told us that the 7(a) loan applications generally go through the same financial analysis and approval process as their regular loans. Officials of two of the visited lending institutions told us that their review process for 7(a) loan applications includes a loan committee review. One of the lenders limited the committee review to 7(a) loan applications of $20,000 and over, while the other lender required that all 7(a) loan applications be reviewed by the loan committee.

We were told by SBA district office officials that although the type of financial analysis performed by the lender is usually self-evident in the letter sent with the borrower's application, the extent of such analysis is not known. A Washington, D.C., district office official told us that he expects the analyses performed on 7(a) loan applications to be the same as those that normally would be performed by a prudent and responsible lender.

SBA loan processing functions

SBA has responsibility for determining whether or not a 7(a) loan should be approved. Therefore, despite the fact that the private lenders initially evaluate the 7(a) guaranteed loan applications, SBA requires that its district offices perform a detailed analysis of each application.

Analyzing the 7(a) guaranteed loan applications and supporting documentation and recommending approval or disapproval of the loan request is the responsibility of loan officers in the district office financing division. The loan officer's analysis should include a determination of the applicant's eligibility for a 7(a) loan; the ability of the applicant to repay the loan from earnings; the adequacy of the collateral pledged to secure the loan; the capability of the applicant firm's management personnel; and the ability of the applicant to obtain the funds without a guarantee. The loan officer is required to evaluate any studies or other information peculiar to the business which the applicant is or will be operating and to make a field visit to the applicant if it is felt that such a visit would be helpful in arriving at a favorable loan decision. The loan officer must prepare a report summarizing the results of his analysis and recommending whether the loan should be approved or declined.

Two SBA district office officials must recommend each 7(a) loan application for approval before the loan can be made. Two of the district offices we visited utilize a committee to review the loan. Once a guaranteed loan has been approved, the district office notifies the private lender of the approval and provides the lender with the legal documents needed to close the loan.

Private lender loan servicing functions

The private lenders are responsible for servicing 7(a) guaranteed loans. The loan guarantee agreement between SBA and the lender requires the lender to follow the same loan servicing standards as would be performed by a prudent lender. Loan servicing usually includes collecting monthly loan installments, obtaining and reviewing financial statements, and notifying SBA of delinquent borrowers and those in need of management assistance. Officials of two of the lending institutions we visited told us that their servicing of 7(a) guaranteed loans also includes providing management assistance to borrowers whenever possible. The loan guarantee agreement requires that the lender obtain SBA approval of certain servicing actions, such as releasing collateral or changing the terms of the note.

Lenders may sell the guaranteed portion of 7(a) guaranteed loans to investors, such as insurance companies, trust and pension funds, and other banks. The lender nevertheless retains responsibility for servicing the loan.

Although SBA's regulations require SBA to assume servicing of a loan after it purchases the guaranteed portion, SBA has sometimes allowed lenders to continue to service loans after purchase by SBA. Although clearly contrary to the regulations, this practice has been allowed by SBA if the lender is willing to continue to service the loan, and SBA determines that continued lender servicing will not be detrimental to the loan. Notwithstanding the existing regulations, an SBA headquarters office official told us that SBA is gradually letting more banks continue to service purchased loans because of SBA's lack of staff.

SBA loan servicing functions

SBA considers its responsibility for the success of a firm receiving a 7(a) guaranteed loan to be the same as for a firm receiving a 7(a) loan directly from SBA.

Therefore, SBA requires that its district office personnel make field visits to 7(a) guaranteed loan borrowers, analyze the borrowers' financial statements, and provide the firms with needed management assistance.

Each 7(a) loan is assigned to a loan specialist in the district office portfolio management division. The loan specialist is responsible for making the field visits and a loan servicing assistant is responsible for analyzing the financial statements. Field visit activities should include counseling the borrower, observing collateral and noting any changes, checking use of loan proceeds, determining whether management assistance is needed, and advising borrowers of assistance programs. Financial statements are analyzed to determine whether any adverse financial trends are evident, such as operating losses or negative net worth. Although each loan is assigned to a loan specialist, the chief of the portfolio management division in one of the district offices we visited told us that the division's five loan officers spend the majority of their time on problem loans.

More detailed work is required on the part of the loan officers for those loans which SBA has purchased under a guaranteed loan agreement. The additional work required includes collecting monthly installments, insuring that adequate insurance and collateral are maintained and taxes are paid, providing management assistance to borrowers, contacting delinquent borrowers, and determining reasons for delinquencies.

Management assistance is viewed by SBA as being an integral part of making a success of a marginal business by identifying problems and correcting them before they cause the business to fail. Management assistance involves generally evaluating the business, determining whether the business can improve its operation, and how it can improve. It also takes into consideration the experience and ability of the company's management and provides counseling when necessary. Management assistance may be provided by SBA management assistance specialists or by outside groups, such as SCORE and ACE.

Loan liquidation functions

Private lenders are required to provide SBA with written notification within 45 days of any delinquent loan which has not been made current. If the loan continues delinquent for 60 days, the lender can request that SBA purchase the guaranteed portion of the loan. A district office official told us that it is usually at this time that the lender would ask that the loan be liquidated.

SBA decides whether or not a 7(a) loan will be liquidated and whether SBA or the lender will conduct the liquidation. The process used for determining whether a loan should be liquidated is similar to the approval process in that the loan specialist must evaluate the case and make a recommendation whether to liquidate the loan. This recommendation must be concurred with by another district office official before the liquidation is approved. Once approved, the loan case is turned over to the loan liquidation officer who, in conjunction with the district counsel and the chief of the portfolio management division, determines whether the lender or SBA will conduct the liquidation. SBA tries to have the lender liquidate those loans where it would be advantageous to SBA, such as the lender is located closer to the borrower than SBA, the lender has prospects for developing a change of ownership, or accounts receivable are being liquidated. When a private lender performs the liquidation, SBA must concur in any action taken by the lender in the liquidation process.

An SBA headquarters official told us that SBA conducts about 85 percent of all 7(a) loan liquidations. In the three district offices we visited, SBA was handling more than 90 percent of the loan liquidations. When SBA conducts the liquidation, the loan liquidation officer prepares the legal documents, protects the collateral, oversees the sale of the collateral, and deposits the funds from the sale. Department of Justice attorneys are used in SBA liquidations where State law requires judicial sale.

OTHER FEDERAL LOAN PROGRAMS

Our review of other Federal loan programs included four business loan programs and a housing loan program. The programs we selected were

--the emergency livestock and the business and industrial loan programs administered by FmHA, Department of Agriculture;

--the business development loan program administered by EDA, Department of Commerce;

--the loan guaranty and insurance program administered by BIA, Department of the Interior; and,

--the veterans housing loan program administered by VA.

With the exception of the VA and BIA programs, the responsibilities of the private lender and the administering agency in each program reviewed are essentially the same as those of the private lender and SBA in the 7(a) program. VA has given certain lenders the authority to approve guaranteed housing loans without prior agency review and concurrence. BIA gives lenders the option to liquidate defaulted loans without prior approval.

Programs in brief

FmHA's emergency livestock program provides temporary emergency credit through guaranteed loans to farmers and ranchers who are primarily engaged in livestock operations to enable them to continue their operations. Under its business and industrial loan program, FmHA guarantees loans of commercial lenders providing financing to firms in rural areas for the purpose of saving and/or creating jobs in rural areas.

EDA's business development loan program provides direct and guaranteed loans to provide industry with financing needed to expand facilities or locate new facilities in areas of high unemployment or low family income. BIA's loan guaranty and insurance program guarantees loans to Indian tribes and their members for economic enterprises which will promote the economic development of the Indians. Loans may be guaranteed up to 90 percent under the business loan programs.

Under its housing program, VA guarantees loans made to veterans and others to purchase, construct, or improve their homes. The guarantee under the housing loan program may not exceed 60 percent, up to a maximum of $17,500.

A detailed description of each of these programs is included in appendix II.

Division of responsibility under the other Federal business loan programs

With the exception of one program, the loan approval, servicing, and liquidation responsibilities under the business loan programs reviewed are generally the same as those of the 7(a) program. Under the BIA program the private lenders are given the option of liquidating a defaulted loan without prior approval.

Loan approval

In each of the business loan programs, the administering agency, like SBA, is responsible for approving the loan guarantee. Also, like SBA, each agency performs an independent analysis of the loan application and supporting documents before approving the loan. The organizational levels at which the loans are analyzed and approved vary among the agencies.

Under each of the business programs, private lenders are expected to perform their own analysis of the loan applications. Lender analysis under the BIA program is facilitated by the fact that BIA usually issues the applicant a certificate of eligibility before the applicant applies to the lender for a loan. However, field office officials of each of the agencies told us that the private lenders' analyses, in many instances, are not provided to the agencies. Thus, the extent to which lenders' and agencies' analyses are duplicated is not known. However, officials at the FmHA Texas State office told us that the lenders do such a poor job in reviewing applications that the FmHA personnel performing the first line of review spend as much time analyzing the applications as though FmHA were making the loans.

When analyzing the business loan applications, the agencies insure that the applicant meets the eligibility requirements and will be able to repay the loan from earnings. Because of the nature of these business loans, special attention is given to the adequacy of the collateral securing the loan. In addition to the collateral, the two FmHA programs usually require the personal guarantees of the principals of the business as further assurance that the loan will be repaid.

Loan servicing

As in the 7(a) loan program, the private lenders are primarily responsible for servicing the loans guaranteed under each of the four business programs. The lender's servicing requirement is contained in each agency's loan guarantee agreement. Generally, the lender's servicing requirements include insuring compliance with covenarts and provisions in the note or loan agreement; receiving principal and interest payments; inspecting collateral; insuring that proper insurance is maintained; and obtaining and analyzing borrowers' financial statements. The private lenders we contacted told us that they service federally guaranteed loans in the same manner as they service their regular commercial loans.

Although the private lenders are primarily responsible for servicing the business loans, each agency requires that it periodically receive the borrowers' financial statements. Also, FmHA and EDA require that their personnel conduct periodic field visits to insure that the lenders are properly servicing the loans. A BIA headquarters official told us that there is only incidental monitoring of the lenders' servicing of BIA loans.

The agencies try to work out the problems of those borrowers who are having trouble meeting monthly payments or those where the agency has purchased the guarantee. An EDA official told us that in these cases his agency tries to help the borrowers because the main focus of the program is to keep people employed.

Loan liquidations

Each of the business programs reviewed requires that the lenders notify the agency in the event of delinquent loan payments. BIA requires that it be notified within 45 days of the occurrence of any uncured delinquent loan while EDA requires that it be notified immediately of any delinquent loan which is not current within 15 days of the loan payment due date. FmHA requires that the lender notify it when a borrower is 30 days past due on a loan payment and is unlikely to bring the account current within 60 days.

The loan liquidation procedures differ from program to program. The lender agreements for the two FmHA programs provide that the lenders will liquidate defaulted loans and the liquidation plan must be approved by FmHA. The agreements provide that FmHA will liquidate loans when the lender and agency do not agree on the lender's liquidation plan. In those cases where FmHA liquidates, the lender is not paid for any loss until after the collateral is sold and the final loss is determined by FmHA. An FmHA headquarters office official told us that FmHA encourages the lenders to liquidate the loans.

Under the business loan program, EDA headquarters approves the liquidation of loans and decides whether EDA or the lender will conduct the liquidation. In a majority of the cases where EDA elects to handle the liquidation, SBA field office personnel are used to perform the actual liquidation. An EDA headquarters official told us that the reason for this arrangement is that EDA's liquidation office is centralized in Washington, D.C., and it is more cost effective to use SBA field office personnel.

For BIA loans which are in default for 60 days, the private lenders have the option of (1) requesting BIA to purchase the guaranteed portion; (2) working out an agreement with the borrower to extend the repayment terms; or (3) advising BIA in writing that suit or foreclosure is necessary and proceed to liquidate the loan. A BIA headquarters office official told us that the lender can liquidate the loan without prior BIA concurrence. BIA, which had had only two loan liquidations at the time of our review, liquidated one of the loans and a lender liquidated the other.

Division of responsibility under the VA housing loan program

The VA housing loan program is unlike the Federal business loan programs we reviewed in that the purpose for which the loans are made is different and more emphasis is placed on the sufficiency of collateral. Also, the extent of the Government's guarantee is much less.

Under the VA housing loan program, supervised lenders (any Federal, State, or private banking institution subject to examination and supervision by an agency of the United States or any State) are authorized to make loans which are automatically guaranteed by VA without prior agency review and approval. Under this procedure the loans are automatically guaranteed at the time of approval by the lender. VA monitors the loan packages to insure that lenders are approving quality loans which comply with the law and regulations. VA will take the automatic guarantee privilege from lenders abusing it. In fiscal year 1977, 42,688 loans of the approximately 363,000 VA housing loans were automatic approvals.

All other lenders, unless specifically authorized by VA to make loans automatically, must process the loan applications through VA for review and approval. VA requires that the application package include the veteran's eligibility certificate, credit reports, and copies of executed sales contracts. VA analyzes the loan to make sure that the veteran is a satisfactory credit risk and that the terms of the loan are reasonable for the veteran's present and anticipated income and expenses. Lenders' analyses of the loan applications under both processes are facilitated by the fact that VA issues a certificate of eligibility to the applicant which informs the lender of the applicant's eligibility for the program.

The lender is responsible for servicing VA loans. VA does not prescribe in detail the manner in which the lenders are to service the loans but requires that the lender follow the same accepted standards of loan servicing as employed by a prudent lender. VA may, when circumstances warrant, supplement the lenders' servicing of defaulted loans. A VA field office official told us, however, that lenders are not servicing VA loans because they have no incentive to do so.

The lender must notify VA in the event of borrower default. Also, a lender must give the VA regional office written notice at least 30 days prior to the commencement of any action to liquidate a loan. VA has 15 days after receipt of such notification to advise the lender whether it concurs with the intended liquidation. A VA regional office official told us that VA, in most cases, concurs with the lender's liquidation notice.

According to VA officials, lenders handle virtually all liquidations. VA establishes the minimum price for which the collateral must be sold. After the collateral is sold, the lender and VA settle the account. If the proceeds are not sufficient to cover the debt, VA pays the lender the difference up to the guarantee.

DIVISION OF RESPONSIBILITY IN THE WISCONSIN STATE PRIMARY MORTGAGE LOAN PROGRAM

Under the Wisconsin State primary mortgage loan program, the State makes direct low-interest loans to veterans of low and moderate incomes. Private lenders do not provide any financing but participate in the program by acting as agents or independent contractors for the State in the loan approval, servicing, and liquidation functions.

Although the program was designed to minimize governmental involvement, the State takes an active role in loan approval, servicing, and liquidation. A Wisconsin Department of Veterans Affairs (DVA) official told us that the State's active involvement in the loan program is to protect the State's financial interests because many of the private lenders participate on a limited basis in the program and are unfamiliar with applicable laws and regulations and some private lenders are not as prudent as they should be in evaluating loan applications.

The private lender's responsibilities under this program include assisting the veteran in preparing the loan application, ordering credit reports, verifying the veteran's income and employment, and appraising the property. The private lender is expected to analyze the loan application according to its normal lending practices and is required to submit the loan package along with its recommendation to DVA. The lender's evaluation of the loan is facilitated by the fact that the applicant receives a certificate of eligibility from DVA.

DVA performs a complete and independent analysis of the entire loan application package to insure that statutory and other loan requirements are met and that a quality loan is being made. After the loan is approved, DVA forwards the funds to the private lender. The private lender is responsible for preparing the loan closing documents and closing the loan for DVA.

As in the other programs reviewed, loan servicing is performed by the private lenders. In this program, private lenders are viewed as independent contractors and receive a monthly loan servicing fee. The loan servicing agreement specifies the lenders' responsibilities which include collecting and paying real estate taxes, special assessments, and insurance premiums; collecting all payments due under the terms of the mortgage; and remitting the mortgage payments, less their servicing fees, to DVA. The lender is also required to provide DVA with monthly reports showing the status of each loan. The lender may not waive or vary the terms of any mortgage or consent to a postponement of any terms or conditions of a mortgage without prior DVA approval. DVA becomes actively involved in servicing those loans where the borrower has become delinquent in making mortgage payments. A DVA official told us that DVA does not get involved in servicing loans which are not delinquent.

Loans which are delinquent 60 days or more are considered in default. At this point the lender must advise DVA of the lender's recommended action. Based upon the lender's input, DVA decides whether or not action should be taken to liquidate the loan.

Although the loan procedures state that lenders are responsible for acquiring title to the property, and DVA is responsible for disposing of the property, a DVA official told us that DVA decides on a case-by-case basis whether it or the lender will conduct foreclosures and liquidation actions. He also told us that DVA usually disposes of the property through real estate listings. At the time of our visit, DVA had liquidated only 17 of the 21,758 loans made as of September 30, 1977.

VIEWS ON PRIVATE LENDERS ASSUMING GREATER 7(a) LOAN PROGRAM RESPONSIBILITY

There was no consensus of opinion among the private lenders and associations regarding transferring additional 7(a) loan program responsibilities. However, the views and opinions of those contacted indicate that some lenders are willing to assume greater responsibility for 7(a) loans.

As with the private lenders, there was no consensus of opinion among the SBA officials interviewed on transferring more responsibilities to the private lenders. However, recent SBA efforts to bring about greater private lender participation in the 7(a) program indicate that it recognizes the potential benefits from more private lender involvement. These efforts are discussed in detail on pages 23 to 25.

Benefits cited by some of the officials interviewed as resulting from more lender responsibility for 7(a) loans included faster loan approvals, greater loan servicing flexibility, and more timely loan liquidations. Some of the concerns expressed regarding giving lenders more responsiblity included (1) potential for abuse in permitting lenders to make loan decisions, (2) whether or not the responsibility to obligate the U.S. Treasury can be legally delegated to private lenders under the Small Business Act, and (3) increased administrative burden and costs to private lenders.

How private lenders view additional responsibility for the 7(a) loan program

Our discussions showed that in most cases private lenders view guaranteed Federal loans in the same manner as nonguaranteed commercial loans in terms of their overall responsibilities. Because they make the loans with their own funds, the private lenders feel responsible for them. In certain instances the private lenders view the guaranteeing agency as a party to the loan because the agency has its own interest to protect.

The private lenders and bankers associations contacted expressed differing views on the feasibility of lenders assuming more responsibility for approving, servicing, and liquidating SBA 7(a) loans. The Independent Bankers Association, for example, reported that it had found a genuine willingness within the association for its member banks to assume greater responsibility for approving, servicing, and liquidating these loans. (See app. III.) The American Bankers Association, however, expressed reservations concerning a shift in responsibilities, such as potential for lender abuse and conflict of interest, increased administrative burden, and SBA's unwillingness to give up control over major loan decisions. (See app. IV.)

Officials of five of the eight lenders contacted which participated in the 7(a) program indicated a willingness to assume greater responsibility for 7(a) loans in at least one of the three functions, and two of the five were willing to assume greater responsibility in all three areas. These two lenders and the IBA felt that no additional inducements are necessary to encourage lenders to assume more responsibility for 7(a) loans. One of the lenders who was unwilling to assume greater responsibility for 7(a) loans told us that there were no incentives which would entice his bank to take on more responsibility for 7(a) loans.

Loan approval

One of the complaints of the private lenders contacted concerned the amount of time it takes SBA to process loan approvals. One of the private lenders commented that SBA loan approvals can take up to 10 weeks. Another lender told us that it takes SBA 3 to 5 weeks to do what the bank does in 1 week. Both lenders felt that giving the banks approval responsibility would result in more timely loan approvals.

In several instances private lenders suggested the possibility of SBA using an automatic approval system for lenders which have demonstrated their competence in making 7(a) loans. Under such a system, the lender would perform all the analysis needed to evaluate the eligibility and creditworthiness of the applicant and SBA would guarantee the loan without an evaluation of the application. To insure the system's reliability, the lenders would have to be regulated by a State or Federal agency or would have to be approved in advance by SBA as automatic approval lenders. This automatic system would be similar to the one employed by VA in its veterans housing loan program.

The IBA endorsed the concept of an automatic loan approval system and pointed out its potential for eliminating major obstacles to the 7(a) guaranteed loan program, such as excessive paperwork, delays in processing, and "red tape." The ABA, however, stated that giving the private lenders more responsibility would carry with it a potential for abuse and conflict of interest in permitting banks to make credit evaluations and lending decisions with respect to loans which will be 90 percent guaranteed by SBA. The ABA further stated that any regulations or standards SBA might adopt to assure credit quality would impose significant administrative burdens and interpretive problems on banks attempting to comply with the regulations.

Two of the lenders contacted were satisfied with the present arrangement of SBA performing an independent evaluation of the loan applications. Both lenders felt that SBA has its own interests to protect and that the SBA evaluation prevents abuses in the program.

Loan servicing

The private lenders contacted felt that they have virtually complete responsibility for the day-to-day servicing of 7(a) loans. However, two lenders felt that they should be given more authority to make decisions on certain matters, such as releasing collateral or modifying the terms or conditions of the loan, without prior concurrence from SBA. One of the two lenders told us that he had been waiting for 3 weeks for SBA to approve his written request to waive the requirement that audited financial statements be obtained for a particular 7(a) loan. He told us that these types of decisions are made routinely by banks and that doing away with the requirement of prior SBA concurrence would provide for greater flexibility in servicing the 7(a) loans.

ABA stated that the present 7(a) program is somewhat troublesome in terms of servicing and administering and that, if private lenders were to take on the entire process, their personnel costs would likely increase substantially. According to ABA, this would result in higher costs to the program borrowers and may possibly result in SBA paying the banks a fee to cover their servicing and processing costs.

IBA reported that its members generally prefer to service loans in which they participate.

Loan liquidations

Although some of the lenders contacted were willing to assume the responsibility for liquidating 7(a) loans, others felt that SBA should continue to conduct the liquidations. One lender told us that he lacked the staff to conduct the liquidations. Another lender expressed concern that the lender handling all aspects of a liquidation would leave the lender open to the possibility that SBA would deny liability under the guarantee because SBA did not agree with the manner in which a liquidation was conducted.

ABA also expressed concern over the fact that SBA would limit its guarantee liability if lenders liquidated 7(a) loans. ABA stated that it doubted that SBA, as 90-percent guarantor of the loan, would want to give up control of the liquidation process. IBA expressed the belief that if lenders were required to handle the liquidation function, they would undoubtedly assume the responsibility for such actions in the same proficient manner as they do in connection with conventional loans.

Three of the lenders contacted were willing to assume responsibility for liquidating 7(a) loans. They felt that the lenders could conduct the liquidations in a more timely manner. One of the lenders told us that certain liquidations conducted by SBA take 2 to 3 years to complete and by that time only a small amount is realized from the liquidation. One reason cited by a lender for this long liquidation time is that SBA must rely on Department of Justice attorneys who are often backlogged with other priority work.

Suggestions by IBA

In the comments provided us, IBA made the following specific suggestions for changes to the law and SBA's regulations to permit or encourage banks to assume greater loan approval, servicing, and liquidation responsibiliies.

--Amend the Small Business Act to authorize supervised lenders to make the determination that the small business assisted has established "reasonable assurance of repayment" in connection with a 7(a) loan application.

--Revise SBA regulations to authorize private lenders to determine borrower eligibility and make credit evaluations as a condition to the automatic issuance of certificates of loan guarantee.

--Revise SBA 7(a) loan processing procedures to incorporate standards for credit evaluation and submission of reports by private lenders to SBA following consummation of each loan.

--Revise SBA regulations to create a new category of lenders who will be certified by SBA after completion of specified training in credit analysis.

--Revise SBA regulations to require lending institutions to carry out the liquidation of each 7(a) loan in a manner acceptable to the Federal Government.

How SBA views private lenders assuming greater responsibility for 7(a) loans

The SBA officials contacted did not agree as to whether private lenders can or should assume greater responsibility for approving, servicing, and liquidating 7(a) loans. The following are some of their comments on these matters.

Loan approvals

Two SBA headquarters office officials said that it may be illegal to transfer the entire 7(a) loan approval function to the private lenders. The Director, Office of Finance, told us that SBA cannot delegate its authority to obligate the U.S. Treasury and that, by giving private lenders automatic approval authority, SBA, in essence, is delegating its approval authority. He said that the present legislation requires that SBA have some input into the loan approval process. The head of the SBA task force evaluating the feasibility of transferring more 7(a) loan responsibilities to private lenders also commented that present legislation requires SBA to certify applicant eligibility and to make the final loan approval decision.

An official of SBA's Office of General Counsel agreed that it may be illegal to transfer the 7(a) loan approval responsibility to private lenders. He told us that although the Small Business Act does not specifically prohibit such a transfer, the act authorizes SBA to make and participate in loans. He questioned how SBA could comply with these provisions if it does not take an active role in the approval of 7(a) loans. According to this official, there is no formal SBA position on this matter.

An SBA district office official told us that although he would like to see the loan approval function turned over to the private lenders, he felt that SBA must continue to make the eligibility decisions. According to this official, the 7(a) program eligibility requirements change frequently and the private lenders are unable to keep abreast of them. Another SBA district office official told us, however, that the private lenders know the eligibility requirements and that the requirements are not too complex for the private lenders to make the eligibility determinations. However, he expressed concern over the fact that bank personnel are changing constantly and do not develop an expertise in the 7(a) program.

One of the two SBA headquarters officials also commented that the concern expressed by ABA that allowing private lenders to assume greater responsibility in the loan approval process might increase the potential for abuse and conflict of interest is not valid. This official pointed out that most private lenders participating in the 7(a) program are supervised by State or Federal regulatory agencies and, therefore, it is not likely that much abuse of their responsibilities will occur.

Loan servicing

Some SBA officials were critical of the manner in which private lenders currently conduct the servicing of 7(a) loans. Officials in the portfolio management divisions of two of the district offices told us that the private lenders do not have adequate staff, and in some cases properly trained staff, to service the 7(a) loans. We were told that, as a result, SBA is servicing and identifying the problem 7(a) loans.

Two officials in SBA's Office of Portfolio Management favored giving the lenders all 7(a) loan servicing responsibilities. One of the officials commented that SBA's primary problem with lender servicing is that lenders are not accustomed to maintaining contact with 7(a) firms to identify those in need of management or other assistance. He attributed this to the fact that lenders view themselves as providers of financing and traditionally have not gotten involved in the management and technical assistance needs of borrowers. This official felt, however, that the private lenders are becoming more aware of the benefits of providing small business with assistance.

Private lenders are currently required to obtain prior approval from SBA before taking actions which would change or modify the provisions of the loan, such as releasing the collateral securing the loan. One of the officials in the Office of Portfolio Management told us that, because SBA approves virtually all the lenders' requests, it appears that requiring SBA concurrence may not be necessary.

Loan liquidations

Several points were raised by SBA officials that impact on the feasibility of transferring 7(a) loan liquidation responsibilities to private lenders. One headquarters office official said that the priority the Government receives in bankruptcies may be lost if responsibility for liquidating loans is transferred to private lenders. Another SBA headquarters official agreed with this statement and also told us that SBA should retain control over 7(a) loan liquidations because SBA may prefer to defer or refinance a loan when a social goal is achieved by keeping the business in operation; that is, a job-creating facility in a high unemployment area. This official noted, however, that SBA would prefer that private lenders handle those 7(a) loan liquidations where the collateral consists of accounts receivable because the lenders have the expertise and can liquidate these types of loans more quickly than SBA.

Comments of a former SBA Administrator

A former SBA Administrator suggested establishing an insurance program and eliminating the guarantee program as it now exists under section 7(a) of the Small Business Act. Under the program, SBA would insure all of a lender's small business loan portfolio. The former Administrator said that by doing this, SBA could spread its risk over all its insured loans, including loans to both marginal and nonmarginal businesses.

The former Administrator said that under the program that he is suggesting SBA would not be required to review loan applications, nor would they be involved in loan approval, servicing, or liquidation functions. As a result, he said that SBA personnel now engaged in these functions could be employed in other activities, such as providing management assistance to borrowers.

The cost of the program would be covered by premiums paid by lenders. These premiums would be based on the total dollar value of loans insured by each lender. Lenders would be required to bear losses up to a certain dollar amount, with SBA bearing the remainder of the loss. Lenders would be required to show that they had incurred losses and to establish the amounts of such losses.

SBA efforts to shift more 7(a) loan responsibilities to private lenders

In September 1976 SBA pilot tested its Accelerated Bank Guarantee program, which was designed to make 7(a) guaranteed loans available to small businesses in a faster time frame than was being experienced under the regular 7(a) guarantee program. Under this program selected banks, using SBA-established criteria, determined the creditworthiness of 7(a) loans. SBA's review of the loan application was limited to determining that the applicant met the small business size standard and type of business requirement. Under the program, SBA could deny a loan approval only if the applicant was not eligible because of size or type of business; SBA had an unsatisfactory experience with the applicant on an existing loan; or SBA had information contrary to that supplied by the lender or applicant concerning the application.

SBA terminated the program in March 1977. The Director of SBA's Office of Finance told us that only 38 guaranteed loans valued at $4.5 million were made during the program test and that it was not a success. This official told us that one of the reasons for the program's lack of success was that the credit criteria established by SBA for the program were too stringent in that banks were willing to make loans without a guarantee to applicants meeting the SBA criteria.

An SBA task force is presently trying to determine whether more 7(a) loan approval, servicing, and liquidation responsibilities can be transferred to the private lenders. At the time of our review, the task force suggestions had been incorporated into a proposed program called the "Bank Certification Program."

Under the certification program, private lenders which have participated satisfactorily in the 7(a) loan program would be certified and delegated responsibility for evaluating loan applications and for recommending loan approvals to SBA. SBA would rely on the certified lenders' recommendations and would approve recommended loans without further review.

The certification program also would lessen SBA responsibilities in the loan servicing area because certified lenders would be authorized to make routine servicing decisions, such as release of collateral or deferment of loan payments, without obtaining SBA concurrence. Also, lenders would continue servicing whether or not the guaranteed portion of the loan had been purchased by SBA.

Certified lenders also would be authorized to liquidate loans. In liquidation situations, the private lender would develop a plan based on guidelines of SBA and notify SBA of intent to liquidate. The lender would liquidate under the plan any cases not involving litigation and cases involving litigation where it is in the best interest of SBA. Liquidation cases would be audited by SBA to insure that proper actions were taken to protect the interest of the United States.

The SBA task force leader told us that with the increased responsibilities the new program will give to private lenders, there will be a potential for lenders to abuse these responsibilities. The task force believes, however, that the lenders selected for the program will realize it is to their advantage to have the increased responsibilities and will make efforts to show SBA they can be trusted. Nevertheless, the task force believes that SBA should issue detailed guidelines designed to minimize the potential for abuse and to closely monitor the performance of each certified lender. If a lender's performance is not satisfactory, its SBA certification would be canceled. Under the certification program, lender certification would be subject to review and renewal on a periodic basis; that is, 2 or 3 years.

The task force is considering modifying SBA's loan guarantee fee as an incentive for lenders to participate in the certification program. Modifications being considered are (1) allowing lenders to pass on to the borrowers the guarantee fee which lenders currently pay SBA or (2) allowing the guarantee fee to be paid in installments throughout the life of the loan instead of in a lump sum at the time the guarantee is issued.

As of January 1978 no changes were made in the 7(a) loan procedures as a result of the task force work. SBA plans a pilot test of the Bank Certification Program in July 1978. The task force leader pointed out that, depending on the exact changes that may be made to the 7(a) loan procedures, legislation may be necessary to allow SBA to delegate 7(a) loan responsibilities to private lenders.

DESCRIPTION OF OTHER FEDERAL AND STATE LOAN PROGRAMS

REVIEWED AND COMPARED TO THE 7(a) LOAN PROGRAM

EMERGENCY LIVESTOCK LOAN PROGRAM

The emergency livestock loan program is administered by the Farmers Home Administration, Department of Agriculture. The program, authorized by the Emergency Livestock Credit Act of 1974 (Public Law No. 93-357, as amended), guarantees loans made by private lenders to farmers and ranchers in the livestock business to permit them to maintain their operations during temporary adverse economic periods. Loans may be made to individuals, partnerships, and corporations who are established bona fide farmers and ranchers in the United States and who are unable to obtain sufficient credit from commercial sources. Borrowers must be primarily and directly engaged in breeding, raising, fattening, or marketing their livestock.

Loan funds may be used for purposes essential to carrying on livestock operations, including replacing livestock, providing feed, paying the usual charges for grazing permits or use of land and buildings, providing farm machinery, moving livestock, and for building or repairing pens and fences.

Emergency livestock loans may be made for a fixed amount or for a line of credit but may not exceed $350,000 in either case. Maximum maturity is 7 years, with renewal possible for up to 3 additional years. The guarantee may not exceed 90 percent. Security consists of liens on livestock, other chattels, real estate, or additional property.

BUSINESS AND INDUSTRIAL LOAN PROGRAM

The business and industrial loan program, which also is administered by FmHA, was authorized by the Rural Development Act of 1972 (7 U.S.C. 1932 (Supp. II, 1972)).

The primary purpose of this program is to improve the economic climate in rural areas by saving existing jobs or creating new jobs. This objective is achieved by assisting and encouraging local lenders to make guaranteed loans to business or industrial enterprises to enable them to expand or locate their operations in rural areas. Indian tribes and political subdivisions of States also are eligible for loans under this program.

This program provides both guaranteed loans and FmHA direct loans. Loans may be guaranteed up to 90 percent of principal and interest, and there is no statutory limit on loan size. Maximum maturity is limited to 30 years for loans made to purchase land and to construct, improve, or purchase buildings and permanent fixtures; 15 years for loans made to purchase machinery and equipment; and 7 years for working capital. Generally, a minimum of 10-percent equity is required and collateral may include real property, chattels, or assignment of rights. There is no requirement that the applicant be unable to obtain credit elsewhere in order to qualify for a guaranteed business and industrial loan.

LOAN GUARANTY AND INSURANCE PROGRAM

The loan guaranty and insurance program, administered by the Bureau of Indian Affairs, Department of the Interior, was authorized by the Indian Financing Act of 1974 (25 U.S.C. 1451). This program is designed to provide Indians and Indian organizations access to private money sources which otherwise would not be available at reasonable rates and terms to finance their economic development. Loans may be used for any purpose which promotes the economic development of the Indians, including educational purposes. Indian organizations, however, are limited as to how much of a loan may be used for making loans to or investing in non-Indian organizations. Only Indians and Alaskan natives eligible for services from BIA can obtain loans.

The guaranteed portion of a BIA loan may not exceed 90 percent of unpaid principal and interest. The aggregate amount of loans to an individual borrower is limited to $100,000. There is no statutory limit on amounts of loans that may be made to Indian organizations. Loan maturity varies up to a maximum of 30 years and borrowers are required to have sufficient collateral, if available, to adequately secure the loans.

BUSINESS DEVELOPMENT LOAN PROGRAM

The business development loan program, administered by the Economic Development Administration, Department of Commerce, was authorized by the Public Works and Economic Development Act of 1965 (42 U.S.C. 3121 *et seq.*).

This program offers guaranteed loans to private industry to expand or locate new facilities in areas of high unemployment or low family income. It seeks to upgrade areas economically by creating or retaining permanent, well-paying jobs for local residents. Assistance is available to most applicants, including sole proprietorships, partnerships, corporations, municipalities, and Indian tribes provided they are located in designated areas and other sources of financing are not available on terms and conditions favorable for the accomplishment of the project.

Although there is no statutory limitation on the amounts of these loans, the guaranteed portion of a loan may not exceed 90 percent of the amount owing on the obligation guaranteed. The maximum loan term varies depending on the intended usage of the funds. Working capital loans may be guaranteed for 5 years, while fixed asset acquisitions may be guaranteed up to 25 years, but cannot exceed the useful life of the assets. All projects are expected to be adequately supported by investment capital. For projects involving working capital, there is a 15-percent equity requirement.

VETERANS HOUSING LOAN PROGRAM

The Veterans Administration's guaranteed housing loan program, authorized by 38 U.S.C. 1801 et seq, is designed to assist veterans, service members, and certain unmarried widows or widowers of veterans in obtaining credit for the construction, purchase, or improvement of homes on more liberal terms than generally are available to nonveterans. There is no requirement for inability of loan applicants to obtain credit elsewhere.

Unlike loans under the other programs reviewed, VA loans are made primarily by mortgage companies and savings and loan associations. Loans are guaranteed up to 60 percent of the loan amount, not to exceed $17,500. Although there is no limit on loan size, the amount of a loan cannot exceed the reasonable value of the house being financed. The house is used as loan collateral and usually covers the amount of the debt. The loans have a maximum maturity of 30 years.

WISCONSIN PRIMARY MORTGAGE LOAN PROGRAM

The Wisconsin State primary mortgage loan program is administered by Wisconsin's Department of Veterans Affairs. Under this program, which is authorized by chapter 208, the Laws of Wisconsin 1973, the State makes loans directly to veterans to cover up to 95 percent of the purchase or construction cost of a house. Loans may also be used to refinance existing indebtedness when the veteran is in legal danger of losing his house and where such refinancing would place his housing indebtedness on a sound financial footing.

To be eligible for a direct loan, the veteran must have been a resident of Wisconsin upon entering the service, or resided in the State for at least 5 years immediately preceding application. In addition, the veteran's income cannot exceed $18,000 and combined veteran and spouse income cannot exceed $20,700; the cost of the housing cannot exceed $42,500 for an existing structure and $47,500 for new construction; retained assets of the veteran may not exceed $1,000; and the veteran must have sufficient unborrowed funds for a minimum 5-percent down-payment. Also, the house must be occupied by the veteran and his family as their principal residence.

Funds for the direct loan program are presently provided through the periodic sale by the State of general obligation bonds. Although private lenders participate in the program, there are no commercial funds involved. The interest rate charged the veteran covers the bond interest costs plus add-ons for the following: private lender servicing fee (3/8 of a percent); DVA administrative costs (1/4 of a percent); and a self-insurance fee (percentage varies). The interest rate charged veterans on housing loans funded by the September 1977 bond issue was about 6 percent.

From the program's inception and up until September 30, 1977, DVA records show that 21,758 loans amounting to about $600 million were made.

President
EDWARD A. TRAUTZ, President
East Lansing State Bank
East Lansing, Michigan [illegible]

First Vice President
IVAN D. FUGATE, Board Chairman
Western National Bank of Denver
Denver, Colorado [illegible]

[illegible]
RAYMOND D. CAMPBELL, President
[illegible]

[illegible]
DONALD R. OSTRAND, [illegible]
[illegible]

Independent
BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE PRESIDENT

EXECUTIVE DIRECTOR: HOWARD BELL • SECRETARY GENE MOORE • ASSOCIATE DIRECTOR BILL McDONALD

[illegible] GRAND RIVER AVENUE, EAST LANSING, MICHIGAN [illegible]

November 15, 1977

Mr. J. J. Bevis
Assistant Regional Manager
U.S. General Accounting Office
Washington Regional Office
5th Floor
803 West Broad Street
Falls Church, Virginia 22046

Dear Mr. Bevis:

As president of the Independent Bankers Association of America, I am pleased to reply to your letter dated October 12, 1977, addressed to Glenn Swanson, our Washington office manager relative to the feasibility of transferring additional responsibility to private lenders in connection with the processing, servicing, and liquidating of Small Business Administration, Section 7(a) loans.

During fiscal year 1977 SBA approved 27,510 7(a) loans which were guaranteed by the agency. Of these loans approximately 20 percent were made to businesses which had prior loan assistance from the Small Business Administration. Therefore, we can conclude that the Agency only assisted 22,000 new business firms out of a total of 9 3/4 million small business firms in the United States.

SBA was created as a temporary agency in 1953 and was made a permanent agency in 1958 in full expectation of expanding assistance through banks to a sizeable segment of the small business community. The achievements to date are not particularly significant from the standpoint of total loans guaranteed by the agency.

If SBA were to reach the numerous small business firms needing assistance throughout the United States and continue to make an independent review of each credit, an extremely heavy burden would be placed upon agency personnel. In all probability it would be necessary to expand the SBA many times its present complement. The inherent cost of such an expansion program would appear to be prohibitive and not in the best interest of the taxpayer.

The key to an expanded loan assistance program to small businesses rests in the delivery system. Within the United States we have over 14,000 commercial banks which are supervised by the Federal Reserve System, Comptroller of the Currency, Federal Deposit Insurance Corporation, and/or state supervisory agencies. Each such institution must comply with lending standards acceptable to the federal or state supervisory authorities. Those loans that do not meet such standards, of course, are subject to being "classified" by the examining authority.

During the past 24 years the SBA has provided service, not only to the small business community, but also to the banking institutions which have been active in the guaranteed lending programs. Lending institutions that did not have the expertise to make a credit evaluation in connection with many small business loans frequently relied on the federal agency to set the standards. Such reliance was particularly evident among the smaller banks and those institutions that specialized in agriculture loans and farm chattel lending. Over the years, however, banks have gained far greater experience in the commercial and industrial loan making through educational programs sponsored by the banking association, as well as through formal courses of training made available through our network of colleges and universities. Furthermore, the experience gained through working with the government agencies in evaluating credit has developed confidence within the banking system which did not exist in the early '50s.

Within the Independent Bankers Association of America we find a genuine willingness to undertake greater responsibility for approving, servicing, and liquidating of 7(a) loans as suggested in your letter. Such a delegation of authority and responsibility would only be prudent, however, if extended to those banks that had demonstrated their capability in processing, servicing, and liquidating loans. This standard could be achieved through a well organized training program sponsored by the Small Business Administration, or by alternatively requiring credentials from banking schools. It has been suggested that those banks which meet an acceptable standard be considered certified lenders and thereby gain entitlement to the added privileges associated with government lending.

A certified lender should be accorded certain privileges and responsibilities. With respect to the processing of guaranteed loans we feel that banks having met the above qualifications could be permitted to exercise a final credit judgement on each loan. Having completed a credit evaluation the bank would comply with the necessary reporting procedures to the Small Business Administration, certifying compliance with SBA eligibility criteria, credit standards, and disbursement procedures. Upon receipt of such a certification, SBA would then issue an incontestable guarantee which would be subject to the usual fraud penalties.

The issuance of an automatic guarantee, as suggested, would eliminate the major obstacles to the 7(a) guaranteed lending program, viz, excess paper work, delays in processing, and the so-called Government red-tape. Of course it would be imperative that each bank extended privileges as a certified lender maintain an acceptable loan processing and servicing record with the Government and refrain from any practices which would disqualify an institution from making credit decisions on obligations to be guaranteed by the Federal Government. Any abuse of the privileges extended would constitute reason for removal of the lending institution from the list of certified lenders.

At the present time banks are authorized to service SBA guaranteed loans and would continue to enjoy fees for such services with no apparent need for amendment in the standard operating procedures. Our member banks generally would prefer to service loans in which they participated. In the event of liquidation, however, we find that many lending institutions have exercised their option under the 7(a) loan procedures to assign the liquidating function to the Federal Government. This relieves the bank of any stigma of a foreclosure action in the community, but places the entire burden for such processing on agency personnel. If banks were required to handle the liquidating function they undoubtedly would assume responsibility for such actions in the same proficient manner that they do in connection with conventional loans.

Insofar as changes that would be needed in SBA's regulations to permit or encourage banks to assume greater loan approval, servicing, liquidating responsibilities, we would submit the following for consideration:

1. Amendment to the Small Business Act authorizing supervised lenders to make the determination that the small business assisted has established "reasonable assurance of repayment" in connection with a 7(a) loan appliation.

2. Amendment of SBA Regulations authorizing banks to make determination as to eligiblity and credit evaluation as a condition to the automatic issuance of the certificate of guarantee.

3. Amendments to 7(a) loan processing procedures incorporating standards for credit evaluation and submission of reports to the SBA following consummation of each loan.

4. Amendment of SBA 7(a) regulations to provide for the creation of a new category of lenders that have been certified following completion of specified training in credit analysis.

5. Amendment to the SBA 7(a) regulations requiring the lending institution to carry out the liquidation of each loan in a manner acceptable to the Federal Government.

It would be difficult to forecast the volume of loan activity that could be generated with such a streamlined lending procedure. It is our opinion, however, that most commercial banks would seek to achieve the status of certified lender, to gain a competitive edge in his community It appears likely that small business entrepeneurs would find a new, and convenient, access to credit through the local banker who would have final authority for making credit determinations and final servicing of each customer's account.

Within the Independent Bankers Association of America we have found rather great interest in the guaranteed loan programs, both with SBA and FmHA. For many banks the guaranteed obligation can solve liquidity problems, since the guaranteed portion of the loan can be sold to secondary market investors and since the guaranteed loan permits a bank to undertake credits which would normally exceed its legal lending authority. Bankers find that the guaranteed loan is an excellent vehicle in leveraging of loan resources and as a means of bringing new capital into non metropolitan areas.

We would fully anticipate that our membership, which is made up of over 7300 banks located primarily in small communities in 41 states, will look to the guaranteed loan as a vital instrument in fulfilling their obligation to local economies.

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In the event that you and your staff would like to exchange further ideas in connection with this innovative suggestion for expansion of guaranteed lending programs we would be most pleased to have you contact Glenn Swanson, our Washington manager, who will arrange for the necessary IBAA participation.

Very truly yours,

Edward A. Trautz
President

EAT/be

APPENDIX IV

AMERICAN BANKERS ASSOCIATION
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Washington, D C
20036

COMMERCIAL LENDING DIVISION

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December 2, 1977

Mr. J. J. Bevis
Assistant Regional Manager
United States General Accounting Office
Washington Regional Office
803 West Broad Street, 5th Floor
Falls Church, Virginia 22046

Dear Mr. Bevis:

We apologize for not responding to your information request by November 15 as requested.

A copy of your request was forwarded to the members of the Association's Small Business Credit Committee late last month, and I will attempt to summarize the comments received and hope they will be useful to you.

1. There would appear to be potential for abuse and conflict of interest in permitting banks to make credit evaluations and lending decisions with respect to loans which will be 90% guaranteed by the SBA. Because of its guaranty exposure for a substantial portion of the loan, the SBA would probably adopt credit guidelines for banks to follow in evaluating credits for SBA guaranteed loans. Any regulations or standards which the SBA adopted to assure credit quality would impose significant administrative burdens and interpretive problems on banks attempting to comply with the regulations. Any inadvertent failure to comply with an SBA guideline would expose the bank to the risk of losing the SBA guaranty.

2. The current 7 (a) program is somewhat onerous in terms of servicing and administrating. If a private lender were to take on the entire process, its manpower costs would likely increase substantially. However, this increased cost could be offset by obtaining a higher yield on SBA loans. Unfortunately this would result in a higher cost to the borrower and we do not think that this is necessarily in accord with the program. Another possibility would be for the SBA to pay the bank a fee to cover these servicing and processing costs.

3. In the workout process it is important to maintain flexibility to compromise claims and to make quick decisions concerning compromise proposals. Because the SBA would have a 90% stake in the results of the workout we would think that it would want to control major decisions made in the workout process. To the extent this dual control requires time and formalities and may involve a substitution of judgment by the SBA for that of the lender in dealing with a workout problem, it would jeopardize the flexibility necessary for an effective workout.

   Current SBA regulations provide that the lending institutions shall take no action with respect to the documentation or the collateral without SBA consent. To provide the flexibility necessary to workouts, the SBA would have to give the lender virtually a free hand in administering the collection process and assurances that actions taken in connection with the collection of the loan would not jeopardize the guaranty.

   In addition, the workout process involves exposure to substantial risk to the borrower and to other creditors. A bank which has 90% of its loan guaranteed may not want to expose itself to that risk without assurance that it would be indemnified by the SBA to its satisfaction. Any action taken by a lender in connection with a workout makes it more likely that the SBA would argue that its guaranty liability is reduced or discharged because of actions of the lender in collecting the loan. We doubt that the SBA as 90% guarantor of the loan would want to give up control of a liquidation process and indemnify the liquidating lender to the extent that would be necessary to preserve the flexibility of decision making that the lender would require and to assure the lender that the guaranty will not be rendered invalid as a result of the lender's action.

Hopefully these comments are of some use to you.

Sincerely,

John S. Clark

John S. Clark

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

THE SMALL BUSINESS ADMINISTRATION NEEDS TO IMPROVE ITS 7(a) LOAN PROGRAM

DIGEST

Under section 7(a) of the Small Business Act, the Small Business Administration guarantees and makes direct loans to small businesses. The 7(a) program is the agency's basic and largest business loan program.

As of June 1975, 80,582 loans valued at $3,930.4 million were outstanding and 6,800 loans valued at $344.1 million were delinquent 60 days or more or in liquidation.

GAO reviewed the 7(a) loan program at 24 of the agency's district offices, randomly selecting and examining 980 loans. (See app. III.)

Although the agency has aided, counseled, and assisted many small businesses throughout the Nation, GAO found problems that require management attention.

Loan proceeds were approved for questionable purposes.

--Numerous loans were approved which merely transferred the risk of loan payment from banks and other creditors to the agency itself. (See pp. 9 to 21.)

--Some loans were made to wealthy businesses not intended to receive assistance. (See pp. 21 to 24.)

The Small Business Administration did not always analyze the prospective borrowers' financial condition adequately or verify the adequacy of collateral pledged. As a result, loans were approved when it was questionable whether they were of such sound value or so secured as to reasonably assure repayment. (See ch. 4.)

The agency did not act effectively after loans were made to increase the chances of borrower success and loan repayment.

GGD-76-24

--Borrowers used loan proceeds for unauthorized purposes which went undetected. (See pp. 36 to 39.)

--The Small Business Administration did not have adequate procedures for detecting delinquent loans and the reasons for the delinquency, and therefore did not know of borrowers in need of help. (See pp. 39 to 44.)

--The agency did not routinely visit borrowers to check their progress. (See pp. 46 to 49.)

--Its management assistance program was not helping businesses to overcome their problems. (See ch. 6.)

A problem which permeates the entire loan process is a shortage or improper alignment of personnel at the district office level.

To correct these problems, the Small Business Administration should take numerous actions, including:

--Insuring clarification of and compliance with established operating procedures.

--Determining its proper staffing level to effectively analyze and service the loans approved. To achieve this level, the agency should consider realigning its current personnel or requesting additional staff from the Congress. If these approaches fail, the only option would be to limit the number of loans approved. (See pp. 25, 34, 54, and 68.)

This is the fifth in a series of reports pursuant to Public Law 93-386, requiring GAO to conduct a full-scale audit of the Small Business Administration. The Congress can use this report in assessing the agency's management; administration; and fulfillment of its legislative mandate to aid, counsel, and assist small businesses.

The Small Business Administration generally agreed with GAO's recommendations. The agency appreciated the overall positive tenor of GAO's report and acknowledged the managerial shortfalls uncovered.

It said that remedial measures are either underway or planned but these must be accomplished within budgetary constraints. (Specific agency comments are discussed on pp. 26, 34, 55, and 69.)

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