

BY THE COMPTROLLER GENERAL

~~1567A~~  
113926

# Report To The Congress

## OF THE UNITED STATES

### Most Borrowers of Economic Opportunity Loans Have Not Succeeded In Business

The Small Business Administration's Economic Opportunity Loans have not been an effective way to help disadvantaged people start or improve their own businesses. More borrowers have defaulted on the loans than have repaid them. Many who paid off their loans have not remained in business. Furthermore, the outlook for borrowers with active loans is not good since many are in financial difficulty.

The program services borrowers whose limited capital, inexperience, and other factors make high rates of loss and business failure unavoidable. Nevertheless, program results could improve if the Small Business Administration changed the way it manages the program and took measures to help borrowers overcome their undercapitalization and inexperience.

If program results do not improve, congressional oversight committees should determine whether the program's objectives could be better achieved by transferring its funds to other Federal programs for disadvantaged businesses.



113926



CED-81-3  
DECEMBER 8, 1980

13313

**For sale by:**

**Superintendent of Documents  
U.S. Government Printing Office  
Washington, D.C. 20402**

**Telephone (202) 783-3238**

**Members of Congress; heads of Federal, State,  
and local government agencies; members of the press;  
and libraries can obtain GAO documents from:**

**U.S. General Accounting Office  
Document Handling and Information  
Services Facility  
P.O. Box 6015  
Gaithersburg, Md. 20760**

**Telephone (202) 275-6241**



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

B-149685

To the President of the Senate and the  
Speaker of the House of Representatives

This report, which was prepared pursuant to Public Law 95-507, discusses the results of the Small Business Administration's Economic Opportunity Loan Program. The report discloses that relatively few borrowers have established lasting businesses and recommends that the Small Business Administration change the way it manages the program and help borrowers overcome their undercapitalization and inexperience.

The report also recommends that if program results do not improve, the congressional oversight committees determine whether the program's objectives could be better achieved by transferring its funds to other Federal programs for disadvantaged businesses.

We are sending copies of this report to the Chairmen, Senate Select Committee on Small Business and House Committee on Small Business; the chairmen of other interested congressional committees; the Director, Office of Management and Budget; and the Administrator, Small Business Administration.

A handwritten signature in black ink, reading "Luther B. Stasth".

Comptroller General  
of the United States



D I G E S T

The Small Business Administration's (SBA's) Economic Opportunity Loan Program has been a means to sustained economic progress for relatively few borrowers. The program's ability to improve the economic condition of low-income and disadvantaged people could be improved if SBA corrected deficiencies in management and operation and employed new techniques to overcome borrowers' inexperience and low capital investment.

This report is one in a series GAO will issue pursuant to Public Law 95-507, which requires GAO to evaluate certain SBA programs.

ORIGIN AND MISSION OF THE PROGRAM

The program originated with the Economic Opportunity Act of 1964, as part of the "war on poverty." Today, it is part of a larger SBA effort, involving several programs, to help socially and/or economically disadvantaged people create and maintain small businesses. (See pp. 1 and 5.)

Through fiscal year 1979, SBA approved over 62,000 loans for about \$1.1 billion. About two-thirds of these loans were made to borrowers directly by SBA; the remainder were bank loans guaranteed by SBA. Most loans have gone to minority-owned businesses.

The program has a difficult mission. It funds businesses that cannot get assistance from other SBA programs or from the private sector. To be eligible for a direct loan, a business must be rejected for financing by two banks and be found unqualified for SBA's principal business loan program, the 7(a) program. Borrowers that GAO sampled were inexperienced, had low personal investments, and operated in disadvantageous locations. They were usually just starting out in business and owned mostly very small retail or

service businesses with low sales and few or no employees. (See pp. 24 to 27.)

RELATIVELY FEW BORROWERS  
HAVE ESTABLISHED LASTING BUSINESSES

SBA had disbursed about 55,000 Economic Opportunity Loans through fiscal year 1978. Thirty percent of these loans were still in the portfolio as of May 1979; 31 percent had been paid in full; and 39 percent had been charged off or placed into liquidation.

Looking at these figures another way: 70 percent of borrowers who received loans through fiscal year 1978 had completed the program (that is, the 31 percent who paid off their loans plus the 39 percent whose loans had been charged off or put in liquidation). About 55 percent of these "program completions" were borrowers who had defaulted on their loans and lost their businesses (that is, borrowers of charged-off or in-liquidation loans). (See pp. 9 to 12.)

To test whether paid-in-full loans indicated the program's achievements, GAO took a statistical sample of loans recorded as paid in full during fiscal years 1969 through 1978 at four SBA district offices. GAO found that the number of paid-in-full loans overstated the number of borrowers who had successfully completed the program and established lasting businesses because

- some loans were paid in full by SBA refinancing and did not represent borrowers leaving the program,
- a few were paid in full through the liquidation of the borrowers' businesses or were erroneously recorded as paid in full, and
- many were paid in full by borrowers who subsequently went out of business.

GAO estimates that only about 1,010, or 15 percent, of the 6,882 borrowers who completed the program at these four district offices were still in business. (See pp. 13 and 14.)

A few of the businesses operated by sampled, paid-in-full borrowers had grown into significant sources of employment, but most were still very small operations with few or no employees. (See pp. 17 and 18.)

GAO's review focused on what happened to borrowers who left the portfolio rather than on the prospects of borrowers who are still in the portfolio. However, the outlook for many borrowers with outstanding loans is not good, since as of June 1980, the proportion of portfolio loans which were delinquent or in liquidation was higher than it had been at the end of any of the last 8 fiscal years.

The costs of producing the relatively few lasting businesses have been high. SBA expects to lose about \$324 million (excluding unpaid interest) on Economic Opportunity Loans disbursed through fiscal year 1979, about 34 percent of all disbursed amounts. The expenses of administering the program would add to this figure but are unknown because they are not accounted for separately from SBA's other loan programs.

The costs of failure to unsuccessful borrowers also must be considered. Many gave up good salaries to enter business and invested almost all their liquid assets. With the failure of their businesses, they were in worse economic condition than before they took on small business ownership. (See pp. 18 and 19.)

#### WHY PROGRAM COSTS AND THE RATE OF BORROWER FAILURE ARE HIGH

The program has produced relatively few lasting businesses for a variety of reasons, some inherent in the program's nature, others related to the way it has been managed and operated. The program's legislative history indicates that SBA was expected to take greater risks in the Economic Opportunity Loan Program than in its regular business loan program. Borrowers' inexperience, low capital investment, and disadvantageous locations have already been mentioned.

In view of the program's purpose and clientele, greater losses and a higher failure rate than customary in Federal business loan programs could be expected. However, the following management and operating deficiencies have contributed to the program's low yield.

---Loan officers at SBA district offices have not adequately examined loan applicants' qualifications and needs by not analyzing their business projections, management abilities, and the adequacy of loan amounts.

---SBA's goals system is incomplete, focusing efforts on lending in quantity but not on lending effectively. Goals have been established for making loans but not for creating successful businesses.

---SBA has been inattentive to program results by not measuring the program's contributions toward improving the economic condition of disadvantaged people.

---In an effort to allocate limited direct-loan money fairly, SBA places loan applicants who meet minimum credit standards on waiting lists and funds them in turn, as money becomes available. As a result, there are long waiting periods for loans, and less qualified applicants may receive loans at the expense of better qualified applicants. (See pp. 31 to 43.)

To reduce loan losses and increase the number of successful businesses produced by the program, GAO recommends that the SBA Administrator

---require better assessments of loan applicants' prospects for establishing successful businesses and the loan amounts most likely to help them reach this goal;

---establish program goals which direct effort toward producing successful, lasting businesses and monitor the progress of the program toward reaching these objectives; and



--upgrade minimum standards for the program so that only the best qualified applicants who can be funded within a reasonable time are admitted to the waiting lists. (See p. 44.)

REMEDIAL MEASURES SHOULD BE TAKEN  
TO HELP BORROWERS AND IMPROVE THE  
PROGRAM'S PRODUCTIVITY

Because the Economic Opportunity Loan Program has social as well as economic goals, and services businesses which cannot qualify for other Federal business lending, some departures from traditional lending practices seem warranted.

SBA has tried some special assistance techniques already--refinancing of troubled loans and granting deferments to borrowers--but without much success. (See pp. 48 to 50.) Three other methods for assisting borrowers--grace periods on initial repayments; graduated repayment schedules under which loan payments would increase as businesses become better established; and early, intensive management assistance--have not been adequately tested because their use has been too limited. (See pp. 47, 48, and 50 to 54.)

Borrowers have not usually accepted management assistance offered to them. In addition, the assistance has come too late--after they have already made crucial decisions on how to locate and operate their businesses and how to spend the loans. The assistance provided has also been too limited--not of a scope or duration consistent with borrower needs. Most borrowers that GAO interviewed reported that the assistance had little effect on their businesses. (See pp. 50 to 56.)

GAO recommends that the SBA Administrator test the effectiveness of three techniques for alleviating borrowers' undercapitalization and inexperience: (1) more extended grace periods on initial principal repayments, (2) the use of graduated loan repayment schedules providing for increasing payments during the life of the loan, and (3) providing more management assistance earlier. (See pp. 57 and 58.) Additional recommendations are on page 58.

The Administrator should also consider applying these recommendations to minority business lending in SBA's 7(a) program, which also has a high rate of borrower default and which is administered by the same organizational units and under the same procedures as the Economic Opportunity Loan Program. (See p. 58.)

#### SBA COMMENTS AND GAO's EVALUATION

SBA said that the program "as a whole" had not failed. It stated that the loans are the highest risk portfolio and asked what percentage of success should be considered acceptable in this type of program.

SBA did not indicate whether it will implement GAO's recommendations nor did it present any additional facts or views which would cause GAO to modify its conclusions or recommendations. SBA did say, however, that one of the most useful changes it could make would be to inform loan applicants of historical program results as presented in GAO's report so that the applicants could better assess the wisdom of starting a business or taking on more debt. GAO agrees. (See app. VI.)

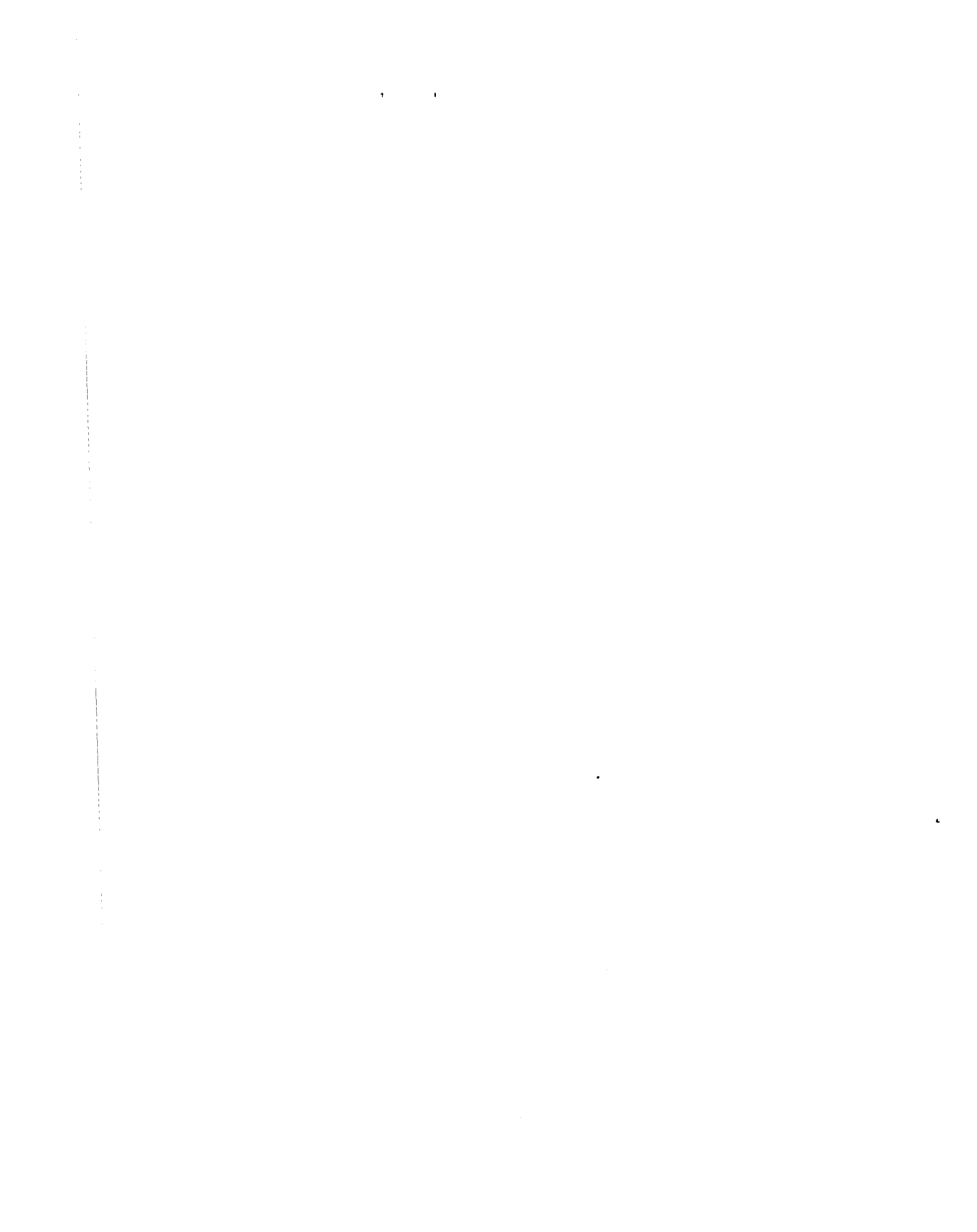
#### RECOMMENDATION TO THE CONGRESS

Borrowers of direct Economic Opportunity Loans pay more interest than better qualified 7(a) direct loan borrowers because the Small Business Act provides different formulas for computing interest under the two programs. The legislative history of the Small Business Act does not indicate that the Congress considered the effect of the two differing formulas. (See pp. 60 and 61.)

The Congress should determine whether the higher interest paid by borrowers of direct Economic Opportunity Loans is justified by the greater risk associated with these loans or whether in fairness to disadvantaged borrowers, the rates for the two programs should be the same. (See p. 66.)

RECOMMENDATION TO THE SENATE SELECT  
COMMITTEE ON SMALL BUSINESS AND THE  
HOUSE COMMITTEE ON SMALL BUSINESS

The committees should monitor SBA's implementation of GAO's recommendations for management improvements and their impact on program results. If results do not improve, the committees should determine whether the objectives of the Economic Opportunity Loan Program could be achieved more efficiently by recommitting the program's funds to other Federal programs for socially and/or economically disadvantaged business owners. (See p. 59.)



# C o n t e n t s

## Page

DIGEST

i

CHAPTER

1	INTRODUCTION	1
	History and purposes of the Economic Opportunity Loan Program	1
	Loan types and terms	2
	Eligibility	3
	Downward trend in loanmaking	3
	Administration of the EOL Program	4
	Where the EOL Program fits in relation to other sources of financing for disadvantaged businesses	5
	Program costs	7
	What past studies of the EOL Program and Federal minority business lending have found	7
	Objectives, scope, and methodology	8
2	FEW EOL BORROWERS HAVE REMAINED IN BUSINESS	9
	Measuring the results of the EOL Program	9
	Why sampled borrowers left business	16
	Only a few sampled businesses have grown	17
	Program costs seem high in relation to output	18
	How to use business survival rates in judging the program's achievements	19
	Conclusion	21
	SBA comments and our evaluation	22
3	REASONS FOR HIGH RATE OF BUSINESS FAILURE AND PROGRAM LOSSES	23
	THE EOL Program services a high-risk clientele	24
	Deficiencies in program management and operation	31
	Conclusions	43
	Recommendations to the SBA Admin- istrator	44
	SBA comments and our evaluation	44

CHAPTER

Page

4	ATTEMPTS TO ASSIST EOL BORROWERS HAVE BEEN INEFFECTIVE	46
	Grace periods and graduated repayment schedules have been underused assistance techniques	47
	Deferments have not saved most borrowers	48
	Refinancing not useful for most troubled borrowers	49
	Management assistance has not been fully developed as a technique for helping borrowers	50
	Conclusions	56
	Recommendations to the SBA Admin- istrator	57
	SBA comments and our evaluation	58
	Recommendation to the Senate Select Committee on Small Business and the House Committee on Small Business	59
5	OTHER OBSERVATIONS	60
	Higher interest charged on direct EOLs	60
	Borrowers' eligibility as socially or economically disadvantaged persons not established	61
	Bank participation in the EOL Program	65
	Conclusions	65
	Recommendation to the SBA Admin- istrator	65
	Recommendation to the Congress	66
6	SCOPE AND METHOD OF THE REVIEW	67
	Sample of EOL borrowers who paid their loans in full	67
	Sample of loans approved during fiscal years 1976 through 1978	71
	Sample of borrowers who received management assistance	72

APPENDIX

I	Other studies of the EOL Program and Federal minority business lending	73
II	EOL default rates and active portfolio classified by borrower and business type	79

APPENDIX

Page

III	Projection of sample results for paid-in-full loans	88
IV	Comparison of borrowers' projections with industry averages computed by Robert Morris Associates	89
V	Selected responses by EOL borrowers to GAO questionnaire on SBA management assistance	92
VI	Letter dated October 15, 1980, from the Acting Administrator, SBA	96

ABBREVIATIONS

ABA	American Bankers Association
EOL	Economic Opportunity Loan
GAO	General Accounting Office
RMA	Robert Morris Associates
SBA	Small Business Administration
SBI	Small Business Institute
SCORE	Service Corps of Retired Executives





## CHAPTER 1

### INTRODUCTION

This is one in a series of reports we will issue pursuant to Public Law 95-507 (approved Oct. 24, 1978) which requires us to evaluate certain Small Business Administration (SBA) programs. The report deals with SBA's Economic Opportunity Loan (EOL) Program, which is authorized by section 7(i) of the Small Business Act to establish, preserve, and improve the management of small businesses, especially those located in areas of high unemployment or low income.

### HISTORY AND PURPOSES OF THE ECONOMIC OPPORTUNITY LOAN PROGRAM

The EOL Program was established by the Economic Opportunity Act of 1964 (Public Law 88-452) as part of the "war on poverty." Major purposes of the program, as indicated by its legislative history, include

- creating new businesses,
- fostering the growth of existing businesses,
- improving the management skills of small business owners,
- improving economic conditions in poor neighborhoods, and
- increasing business ownership among minority group members.

The program's legislative history also distinguishes it from SBA's major business loan program, the 7(a) program. The EOL Program was to be tailored more closely to the special needs of very small businesses operating at marginal levels; credit standards were to be more flexible; requirements for a level of capital investment by the borrower were to be less strict. Nevertheless, loans were not to be made unless there was a "reasonable assurance of repayment."

Public Law 93-386 (approved Aug. 23, 1974) transferred authority for the EOL Program from the Economic Opportunity Act of 1964 to the Small Business Act.

## LOAN TYPES AND TERMS

EOLs are classified on the basis of whether they are made by SBA, by a lending institution, or by SBA and a lending institution jointly.

--A direct loan is made by SBA with no participation by a lending institution.

--A guaranteed loan is made by a lending institution under an agreement which obligates SBA to purchase up to 90 percent of the loan's outstanding balance upon default for more than 90 days.

--An immediate participation loan is made by either SBA or a lending institution under an agreement requiring the other party to purchase an agreed percentage of the loan immediately upon disbursement. The SBA share of an immediate participation loan generally cannot exceed 75 percent of the loan amount.

According to SBA regulations, a direct loan will not be made if a guaranteed or immediate participation loan is available, and an immediate participation loan will not be made if a guaranteed loan is available.

The interest rate on direct loans and SBA's share of immediate participation loans is based on the cost of Government borrowings. The rate on guaranteed loans and on the bank's share of immediate participation loans is set by the bank within a limit established by SBA. As of July 1, 1980, the interest rate on direct EOLs and on SBA's share of immediate participation loans was 9-3/8 percent; the limit on guaranteed loans with maturities of less than 7 years was 2-1/4 percentage points over the prime rate (2-3/4 percentage points for loans with maturities of 7 years or more); and the limit on a bank's portion of an immediate participation loan was 1 percent below the guaranteed loan rate.

EOLs may be made for as much as \$100,000 1/ and for as long as 15 years.

As the chart below shows, the actual term and amount of most loans have not approached the statutory maximums.

---

1/The loan ceiling was increased by law from \$25,000 to \$50,000 in 1972 and to \$100,000 in 1976.

	EOLs in portfolio on <u>9/30/78</u>	EOLs approved in fiscal year <u>1978</u>
Median maturity	7.9 years	7.5 years
Median amount	\$18,000	\$23,000

#### ELIGIBILITY

To be eligible for an EOL under SBA regulations, a business must be at least 50 percent owned by a person(s) who either (1) has low income or (2) has been denied access to adequate financing on reasonable terms through normal lending channels because of social or economic disadvantage. Low income is defined as inability to meet basic family needs. Social or economic disadvantage, according to SBA's standard operating procedures, can result from a number of factors, including

- social background, past practices of discrimination, or, under some circumstances, being a member of a minority group;
- physical handicap;
- residence in an urban area with high concentrations of unemployed or low-income persons;
- residence and business location in an economically depressed area where the local banking community is unable or unwilling to provide financing for small business; or
- being an honorably discharged Vietnam-era veteran.

Most EOLs go to minority-owned businesses. For example, in fiscal year 1979, SBA targeted 81 percent of direct loans and 62 percent of all loans for minority businesses. In that year, minority-owned businesses actually received about 75 percent of direct loans and 65 percent of all loans.

#### DOWNWARD TREND IN LOANMAKING

From fiscal year 1965 when the program began, through fiscal year 1979, 62,603 EOLs totaling over \$1 billion have been approved. Program activity peaked in fiscal year 1973, when 7,666 loans were made or guaranteed for \$133 million. Especially in terms of the number of businesses getting

loans, <sup>1/</sup> the program today is much smaller than it was in 1973. The following chart shows the number and dollar amount of EOLs approved by year since the program began.

EOLs Approved by Fiscal Year

<u>Fiscal year</u>	<u>Direct loan</u>		<u>Guaranteed loan</u>		<u>Total (note a)</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
		(millions)		(millions)		(millions)
1965	150	\$ 1.5	6	\$ .1	158	\$ 1.6
1966	1,642	16.5	38	.4	1,705	17.3
1967	2,804	27.8	147	1.8	3,034	30.8
1968	2,438	24.0	361	4.4	2,905	30.1
1969	2,438	24.6	1,661	20.4	4,243	47.1
1970	3,696	42.9	1,707	21.9	5,533	66.6
1971	4,790	57.9	1,929	25.3	6,786	84.2
1972	5,308	58.6	1,826	24.2	7,170	83.3
1973	4,155	67.7	3,470	64.5	7,666	133.3
1974	3,301	57.1	1,956	39.6	5,281	97.3
1975	2,589	47.0	994	18.3	3,614	66.1
1976	2,405	48.6	1,235	28.6	3,651	77.5
TQ (note b)	560	12.3	304	7.9	867	20.3
1977	2,189	55.0	1,645	45.1	3,849	100.6
1978	1,983	56.1	1,311	41.6	3,300	98.0
1979	<u>1,857</u>	<u>61.4</u>	<u>973</u>	<u>34.1</u>	<u>2,841</u>	<u>96.0</u>
Total	<u>42,305</u>	<u>\$659.0</u>	<u>19,563</u>	<u>\$378.2</u>	<u>62,603</u>	<u>\$1,050.1</u>

a/The number and amount of direct and guaranteed loans do not add up to total loans because the total includes immediate participation loans, a relatively minor segment of all lending. In the period shown, 735 immediate participation loans were approved for about \$12,875,000.

b/Transition quarter.

ADMINISTRATION OF THE EOL PROGRAM

As of June 1980, SBA operated 80 field offices which were authorized to make EOLs. Most of these field offices are

---

<sup>1/</sup>In this report, the number of loans is used as an approximation for the number of borrowers. SBA's automatic data processing records do not indicate how many borrowers received more than one loan.

district offices which report to one of the 10 SBA regional offices. The regional offices in turn report to SBA headquarters, which sets overall policy for the program.

Each district office contains, among other units, a financing division, a portfolio management division, and a management assistance division whose duties as they relate to the EOL Program include the following:

- The financing division processes and approves or declines loan applications.
- The portfolio management division services loans, monitors borrowers' payments and business status, and, when necessary, liquidates defaulted loans. 1/
- The management assistance division sponsors classes on business management and provides individual counseling through various programs including (1) management consulting firms under contract with SBA for this purpose (the Call Contracting Program), (2) volunteers from the Service Corps of Retired Executives (SCORE), or (3) university students participating in the Small Business Institute (SBI) Program.

WHERE THE EOL PROGRAM FITS IN RELATION  
TO OTHER SOURCES OF FINANCING  
FOR DISADVANTAGED BUSINESSES

The EOL Program is part of a larger Federal effort to assist businesses owned by socially and/or economically disadvantaged people through programs of financial, procurement, and management assistance. Disadvantaged businesses are also eligible for other Federal programs directed at small businesses generally. In addition, the private sector is a major provider of financing for minority-owned business. Some sources of financial assistance are discussed below.

SBA credit programs

SBA's principal small business lending program, the 7(a) program, is also its main supplier of loans for minority businesses. In fiscal year 1979, 3,521 7(a) loans were approved for minority businesses, almost twice as many as under the

---

1/In some district offices, loan liquidation is carried on in a separate division.

EOL Program. The value of these 7(a) loans to minority businesses was \$308.7 million, almost five times as much as the amount of EOLs to minority businesses that year. The EOL Program is first in one respect, however; it supplies more direct loans to minority businesses: 1,363 direct EOLs compared to 1,299 direct 7(a)s in fiscal year 1979.

Minority business lending in the 7(a) program differs from the EOL Program in several respects. Credit standards for 7(a) loans are higher than for EOLs. The better qualified loan applicants are assigned to the 7(a) program, the less qualified to the EOL Program. The maximum loan amount for 7(a) loans is \$500,000 versus \$100,000 for EOLs. Minority loans under 7(a) tend to be much larger than minority EOLs: in fiscal year 1979, the average 7(a) loan was about \$87,700; the average EOL was about \$34,000. The differences in default and repayment rates for the two programs are discussed in the next section.

SBA's 301(d) Small Business Investment Company Program provides financing to privately owned investment companies which invest in disadvantaged small businesses. In calendar year 1979, 301(d) investment company financings totaled \$35.1 million, mostly in the form of loans. Most 301(d) company financings go to larger firms than the average EOL borrower we sampled. (See ch. 3.)

### Private sector lending

Most financing for minority businesses comes from the private sector, according to available data.

Based on a survey conducted in 1975, the American Bankers Association (ABA) estimated that in 1974 banks lent \$1.6 billion to minority businesses and had portfolios of minority business loans totaling \$2.4 billion. <sup>1/</sup> In fiscal year 1974, EOLs totaling about \$74 million were approved for minority businesses, less than 5 percent of total estimated minority business bank lending. Data is not available on the amount of EOLs outstanding to minority businesses at the end of 1974, but total EOLs then outstanding (to both minority and nonminority businesses) amounted to \$322.7 million, or about 13 percent of total minority bank loans outstanding.

Banks which responded to the ABA's survey reported that only 18 percent of their minority business loans were guaranteed by SBA. The ABA's survey report does not indicate

---

<sup>1/</sup>These figures were described as rough estimates by an ABA commercial lending specialist.

the terms of loans made by banks on an unguaranteed basis. According to an ABA commercial lending specialist, SBA may make longer term loans to minority businesses than banks.

The ABA has not updated its survey. The chief of the Capital Development Branch of the Department of Commerce's Office of Minority Business Enterprise 1/ told us in June 1979 that bank lending to minority business has not declined in recent years.

#### PROGRAM COSTS

SBA estimates that losses on EOLs disbursed through fiscal year 1979, excluding unpaid interest, will total \$323.6 million, about 34 percent of all amounts disbursed. The costs of administering the EOL Program are not accounted for by SBA separately from its other loan programs. (See ch. 2 for more details.)

#### WHAT PAST STUDIES OF THE EOL PROGRAM AND FEDERAL MINORITY BUSINESS LENDING HAVE FOUND

The EOL Program has been evaluated several times, sometimes as an independent program, sometimes as a part of a broader examination of Federal minority business development efforts. Reviews have been made by us, SBA internal auditors, and the Commerce and Treasury Departments. (App. I to this report presents summaries and excerpts from some of the studies.) These evaluations have been critical of the program's management and results. Major deficiencies reported have included

- an emphasis on the quantity of loanmaking instead of on its effects,
- inattention to what the program was achieving,
- weak credit analysis of loan applicants,
- superficial examinations of borrowers' eligibility,
- lending to firms with doubtful viability or little growth potential,

---

1/Now known as the Minority Business Development Agency

--ineffective management assistance, and

--high rates of loan default and business failure among borrowers.

Although we and others have made recommendations for improvements and we were informed of planned corrective action, these problems have persisted. (See ch. 2, 3, 4, and 5.) SBA has not implemented our recommendations. (See app. I.)

#### OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with our mandate under Public Law 95-507, the principal objective of our review was to determine the effectiveness of the EOL Program in increasing business ownership by disadvantaged people. We also reviewed the program to determine if improvements in its management would possibly increase its effectiveness.

To accomplish these objectives, we analyzed data on the repayment and default of EOLs, analyzed samples of EOLs, and interviewed EOL borrowers who had repaid their loans or received management assistance.

More details on the scope and method of our review are presented in chapter 6.



## CHAPTER 2

### FEW EOL BORROWERS HAVE REMAINED IN BUSINESS

Small business ownership has been a vehicle for the economic advancement of relatively few EOL borrowers. The program has produced some lasting businesses, but the number seems unacceptably small in relation to Federal losses and the costs of failure to unsuccessful borrowers. Most borrowers who left the program through May 1979 defaulted on their loans and lost their businesses. In addition, our work with a random sample of paid-in-full loans at SBA's New York, Miami, Chicago, and Los Angeles district offices indicated that even most borrowers who paid off their loans have not established lasting businesses. Overall we estimate that only 1,010, or 15 percent, of the 6,882 borrowers who left the program (by either defaulting on their loans or paying them in full) at the four district offices from fiscal years 1969 through 1978 are still in business. A few of the borrowers who remained in business have established substantial enterprises which are a source of employment for their communities, but most have not grown.

#### MEASURING THE RESULTS OF THE EOL PROGRAM

In view of the program's legislative intent, the best practical measure of the program's achievements is the number of borrowers who have established lasting businesses. To make this measurement we

- analyzed SBA's nationwide data on the repayment and default rates of EOLs and
- sampled borrowers at four SBA offices who had repaid their loans to determine which were still in business and whether their businesses still existed at the time of our review (April to December 1979).

#### EOL repayment and default

The following table shows the status, as of May 1979, of the number of EOLs disbursed from the start of the program through fiscal year 1978.

<u>Loan status</u>	<u>Number</u>	<u>Percent</u>
Active portfolio	16,618	30
Paid in full	17,229	31
Defaulted loans		
In liquidation		
(note a)	2,414	
Charged off		
(note b)	<u>18,835</u>	<u>39</u>
 Total	 <u>c/55,096</u>	 <u>100</u>

a/According to SBA procedures, a loan is placed in liquidation when it is necessary to resort to the collateral or otherwise enforce collection. Liquidation may occur for a number of reasons, including the impracticality of regular debt retirement despite diligent collection efforts and management assistance.

b/A loan is charged off to recognize a loss for SBA's records. Loans are usually placed in liquidation before being charged off.

c/Differences exist between the number of loans reflected in this table and the table on page 4 because of cancellations and delays in disbursements.

Looking at these figures from another viewpoint: 70 percent of borrowers who received loans through fiscal year 1978 had left the program by May 1979--that is, their loans were no longer in the active portfolio but were either charged off or in liquidation (39 percent of disbursed loans) or had been paid in full (31 percent of disbursed loans). About 55 percent of these "program completions" were borrowers who defaulted on their loans and lost their businesses. 1/

---

1/Officials of SBA's Office of Portfolio Management told us that with few exceptions, SBA does not permit a business whose loan is charged off or put into liquidation to continue operating.

To put the EOL Program repayment and default rates in perspective, the following table shows the ratios discussed above for the EOL Program, with comparable figures for all 7(a) loans approved from program inception through fiscal year 1978, and for 7(a) loans to minority businesses disbursed during the same period.

	<u>EOL</u>	<u>All 7(a)</u>	<u>7(a) Minority</u>
Defaulted loans (note a) as a percent of loans disbursed	39	11	20
Defaulted loans (note a) as a percent of program completions	55	18	40
Active portfolio as a percent of loans disbursed	30	38	48

a/Loans which have been charged off or placed in liquidation.

We analyzed, with the help of a computer, SBA records relating to the repayment and default of EOLs in various categories. Partial results of this analysis with respect to direct and guaranteed loans and minority and nonminority lending are shown in the following table. See appendix II for more information on these ratios and for an analysis of lending to borrowers classified by the amount of their loans, their family incomes, and whether their businesses were new or existing at loan approval.

EOL Default Rate and Active Portfolio  
by Loan and Borrower Type

<u>Ratio and</u> <u>type of loan</u>	<u>Minority</u>	<u>Nonminority</u>	<u>Not coded</u> <u>(note b)</u>
Defaulted loans (note a) as a percent of loans disbursed:			
Direct	42	40	51
Guaranteed	34	23	30
Defaulted loans (note a) as a percent of program completions:			
Direct	63	56	55
Guaranteed	48	37	24
Active portfolio as a percent of loans disbursed:			
Direct	33	29	7
Guaranteed	29	38	4

a/Loans which have been charged off or placed in liquidation.

b/The records for 4,530 loans (8.2 percent of all loans disbursed) do not indicate whether the borrower was a minority group member or not. Most of these uncoded loans were made early in the program's history as is indicated by the small proportion still outstanding in the portfolio. See appendix II for the number of loans disbursed in the above categories.

The table above shows that borrowers of direct loans have been much less successful than guaranteed borrowers. Minority-owned businesses have not been as successful as non-minority businesses except that guaranteed minority borrowers have fared better than nonminority direct loan borrowers.

What happened to borrowers who repaid their loans--  
our sample results

The nationwide statistics on loan repayment discussed in the preceding section give some indication as to how productive the EOL Program has been in creating and maintaining businesses. Loans which were charged off or in liquidation represent business failures. Loans which were paid in full point to a degree of business success.

To test the reliability of the number of paid-in-full borrowers as an indicator of long-term business success, we reviewed a sample of these loans at SBA's Chicago, New York, Los Angeles, and Miami district offices which were paid off during fiscal years 1969 through 1978.

Borrowers of 6,882 loans left the EOL portfolio at these four district offices from fiscal year 1969 through 1978. 1/ Almost 60 percent of these loans had been charged off during the period or were in liquidation at the end of the period; the remaining 2,779 loans were listed as "paid in full" on SBA records. We randomly selected repaid loans to find out what had become of their borrowers.

We found that the number of paid-in-full loans overstated the number of borrowers who successfully completed the program and established lasting businesses because (1) some loans were paid in full by SBA refinancing and did not represent borrowers leaving the program, (2) a few were paid in full by the liquidation of the borrowers' businesses or were erroneously recorded as paid in full, and (3) many were paid off by borrowers who subsequently left business and whose businesses have terminated.

We estimate that only 1,010, or about 15 percent, of the 6,882 borrowers who left the program at the four cities during the 10-year sample period were in business at the time of our review. This estimate is derived as follows:

---

1/A total of 2,792 EOLs were in the active portfolios of the offices at the end of the period.

	Number (notes a and b)	Percent (notes a and b)
Loans which left the portfolio	6,882	100
Less loans charged off or in liquidation	<u>4,103</u>	<u>60</u>
Loans recorded as paid in full	2,779	40
Less loans refinanced, paid in full through liquidation, or misclassified	<u>550</u>	<u>8</u>
Loans paid in full by borrowers leaving the program with going businesses	2,230	32
Less paid-in-full borrowers no longer in business	<u>1,230</u>	<u>18</u>
Borrowers still in business	<u>1,010</u>	<u>15</u>

a/See appendix III for sampling errors.

b/Detail may not add up to total because of rounding of estimates.

We also estimate that about 1,440, or 21 percent, of the businesses for which borrowers received loans still existed at the time of our review. The number of surviving businesses exceeds the number of borrowers still in business because some borrowers sold their EOL-funded businesses and did not start other businesses. Chapter 6 of this report contains greater details on the sample and methods on which these estimates are based.

#### What happened over time to borrowers who repaid their loans

Our sample included 231 borrowers <sup>1/</sup> at the four district offices who repaid their loans over a 10-year period extending from fiscal years 1969 through 1978. Thus, the sample included borrowers who repaid their loans as little as 1 year

---

<sup>1/</sup>Excludes borrowers of loans which were refinanced, paid in full by liquidation, or misclassified as paid in full.

before our review to as long as 10 years before. As the following chart demonstrates, there was a tendency for sampled borrowers to leave business and for their businesses to terminate as the years from loan repayment passed. Of the 51 borrowers who repaid their loans in the first 5 years of our sample period (fiscal years 1969 through 1973), only 11, or 22 percent, were still in business at the time of our review; only 20, or 41 percent, 1/ of their businesses still existed. None of the borrowers who repaid their loans in fiscal years 1969 and 1970 were still in business.

Status of Sampled Borrowers and Businesses  
by Fiscal Year in Which Loan Was  
Paid in Full (note a)

	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u> (note b)	<u>1978</u>	<u>Total</u>
Borrowers still in business:											
Yes	0	0	1	5	5	5	6	23	26	33	104
No	5	7	7	9	12	17	10	24	24	12	127
Business still in existence (note c):											
Yes	0	2	2	9	7	11	8	28	28	34	129
No	5	5	6	5	8	11	8	16	12	10	86

a/Represents unweighted tabulation of the sample data.

b/Includes the transition quarter.

c/Figures exclude one business whose existence or non-existence could not be determined, and 15 New York City taxis which, for the reasons indicated in chapter 6, have to be treated separately when considering the survival of businesses.

1/Based on 49 businesses. See note "c" on chart.

## WHY SAMPLED BORROWERS LEFT BUSINESS

One hundred and twenty-seven of our sampled borrowers at the four district offices were no longer in business. We determined, usually through interviews with them, why 43 of these borrowers left their businesses. (We could not locate most of the remaining borrowers.) These reasons were as follows:

<u>Reason for leaving business</u>	<u>Number of borrowers</u>
Dissatisfied with income provided or other financial cause	16
Retired	12
Deceased	4
Other	<u>11</u>
Total	<u>43</u>

The "other" category in the table includes borrowers who gave varying reasons for getting out of business. The "other" reasons were as follows:

- Grew tired of cab business.
- Wanted different type of business.
- Quit business to take care of sick wife.
- Urban renewal tore business down.
- Desired to change occupation.
- Overworked.
- Sold business because of accident.
- Became fearful due to robberies and assaults.
- Business was requiring too many hours.
- Planned to move family to Arizona.
- Dissatisfied with owner of the property on which the business was located.



It is difficult to judge how many retirements and "other" reasons were related to dissatisfaction with the income produced by the business. However, it is noteworthy that 63 percent of the businesses owned by the 43 borrowers shown in the preceding table no longer existed at the time of our review.

ONLY A FEW SAMPLED BUSINESSES HAVE GROWN

A few sampled borrowers who paid their loans in full at the four cities have grown into significant sources of employment, but most businesses are still very small operations with few or no employees.

Seventy-nine of the 104 sampled borrowers who were still in business provided us with information on the number of their employees as of December 31, 1978. This information is presented in the following chart.

Number of Employees of Sampled  
Borrowers at December 31, 1978 (note a)

<u>Number of full time equivalent employees (note b)</u>	<u>Number of borrowers</u>	<u>Number of jobs</u>
0	25	0
1	10	10
2	13	26
3	7	21
4	3	12
5	4	20
6	5	30
7	2	14
9	2	18
10	2	20
12	1	12
14	1	14
15	2	30
60	1	60
100	<u>1</u>	<u>100</u>
Total	<u>79</u>	<u>387</u>

a/Represents unweighted tabulation of the sample data.

b/Excludes owners and unpaid members of the owners' families.

These 79 borrowers had produced a net addition of 238 jobs since their loans were approved, as shown in the following table. Most of the increase was accounted for by two firms.

<u>Number of borrowers</u>	<u>Change in the number of employees between loan approval and 12/31/78 (note a)</u>	<u>Total difference in jobs</u>
1	-10	-10
1	- 6	- 6
2	- 4	- 8
3	- 3	- 9
8	- 1	- 8
27	0	0
14	1	14
6	2	12
2	3	6
4	4	16
3	5	15
1	6	6
3	10	30
2	12	24
1	57	57
<u>1</u>	<u>99</u>	<u>99</u>
Total <u>79</u>		<u>238</u>

a/Represents unweighted tabulation of the sample results.

PROGRAM COSTS SEEM HIGH  
IN RELATION TO OUTPUT

Three types of costs are associated with the EOL Program: losses on defaulted loans, expenses of administering the program, and the costs of failure to unsuccessful borrowers.

As mentioned in chapter 1, SBA estimates that losses on EOLs disbursed through fiscal year 1979 will total \$323.6 million. At the four SBA district offices we reviewed, \$42.9 million was charged off on EOLs during the 10-year period; loans valued at \$10.1 million were in liquidation at the end of the sample period. These losses of \$53 million 1/

---

1/This figure is an approximation which assumes that there will be no recovery on the loans in liquidation. As discussed in chapter 3, there was little recovery on sampled loans which went through liquidation.

represent over \$52,000 for each of the estimated 1,010 borrowers who were still in business in the four districts we reviewed.

The costs of administering the EOL Program are not regularly computed by SBA apart from the administrative expenses of its other loan programs. However, in a special study of fiscal year 1976 costs, SBA's Budget Division estimated that the total administrative costs for the EOL Program that year were \$13.9 million, exclusive of loan losses.

The burden of business failure also rests heavily on borrowers. The loan repayment figures presented on page 10 show that most of the borrowers who had left the program as of May 1979 failed in business. As will be discussed in chapter 3, many borrowers who established businesses with the help of an EOL were mature people with good-paying jobs who invested almost all their liquid assets in the new business. With the failure of their businesses, these borrowers were in worse economic condition than before they took on small business ownership.

#### HOW TO USE BUSINESS SURVIVAL RATES IN JUDGING THE PROGRAM'S ACHIEVEMENTS

We regard our estimates of the number of surviving businesses and borrowers (see p. 14) as useful indexes of the program's results at the four district offices. However, the survival rates should be viewed in light of the following four considerations.

1. The program produces some benefits not measured by survival rates. Some paid-in-full borrowers who are no longer in business and some whose businesses have terminated may have received a satisfactory income from the business while it survived.

2. The rates focus on historical results rather than on future possibilities. Our review concentrated on what happened to borrowers who left the portfolio (70 percent of loans disbursed) rather than on the prospects of borrowers who are still in the portfolio. However, the outlook for many of these borrowers is not good, since as of June 1980 (the latest information now available), the percentage of "trouble loans" <sup>1/</sup> in the EOL portfolio was higher than it had been at the end of any fiscal year since 1972

---

<sup>1/</sup>SBA's term for loans in liquidation or seriously delinquent.

(the earliest fiscal year for which we have data). The following chart shows the percent of the EOL portfolio which was in the trouble loan category at the end of fiscal years 1972 through 1979.

<u>Fiscal year</u>	<u>Trouble loans as a percent of total portfolio</u>
1972	21.0
1973	21.4
1974	25.1
1975	23.3
1976 (note a)	22.4
1977	25.3
1978	25.1
1979	27.2

a/The figures for 1976 and subsequent years include delinquent guaranteed loans reported to SBA under a new bank reporting system.

The trouble loan rate as of June 1980 was 30.8 percent.

3. Some borrowers might be in business and some financed businesses might exist even if no EOL had been approved. We asked 91 of the 104 borrowers who were still in business about the impact of their EOLs. They responded as follows: 1/

---

1/Represents unweighted tabulation of the sample results.

	<u>Number of borrowers</u>	<u>Percent</u>
Probably would not be in business today	32	35
Probably would be in business but at a much reduced level	9	10
Probably would be in business but at a moderately reduced level	10	11
Probably would be in business but at a somewhat reduced level	12	13
Probably would be in business at about the same level	<u>28</u>	<u>31</u>
Total	<u>91</u>	<u>100</u>

In addition, the number of surviving businesses may overstate program accomplishments in increasing businesses owned by disadvantaged people, since some of these surviving businesses may represent opportunities which could have been developed by disadvantaged people without EOL financing.

4. Decisions on whether to classify borrowers as "still in business" or "no longer in business" involved judgment. Many of the borrowers we classified as no longer in business could not be located and were presumed to be out of business. We believe we had a good basis for making the presumption because of the methods we used to attempt to locate borrowers and because most of these borrowers' businesses no longer existed. (See ch. 6 for details.) Nevertheless, it is possible that some borrowers we could not find had relocated elsewhere in the country.

#### CONCLUSION

The Economic Opportunity Loan Program has helped some disadvantaged people start and successfully operate small businesses. It has added to the number of businesses in economically depressed areas. But costs have been high.

Federal losses in the program are estimated by SBA at about \$324 million on loans disbursed through fiscal

year 1979. The costs of administration would add to this amount, but they are unknown. Most borrowers who left the program through fiscal year 1978 failed in business, losing part or all of their EOL funds and their own investment. Even most of the borrowers who paid off their loans at the cities we visited have not remained in business. Only a small number have grown significantly. Small business ownership has been a means to economic betterment for relatively few EOL borrowers who have so far left the program. In addition, the outlook for many borrowers presently in the portfolio is not good, since the percentage of outstanding loans which are in liquidation or seriously delinquent is higher now than at the end of any of the last 8 fiscal years.

We believe that on balance, program results have been unsatisfactory. New approaches may increase the program's effectiveness in relation to its costs. (See chs. 3 and 4.)

#### SBA COMMENTS AND OUR EVALUATION

In its written comments on our report (see app. VI), SBA said that the program "as a whole" had not failed. SBA asked a series of questions: "\* \* \* what results should be expected for a [high risk program]? Is a 15 percent success rate acceptable or not? The report implies 15 percent successful firms is not acceptable. What rate is?"

For the reasons discussed on pages 19 to 21, it is an oversimplification to refer to our projection of borrowers who remained in business at the four cities we visited as a "success rate." The level of program achievement which could be described as "acceptable" is a matter of judgment. As the agency entrusted with the management of the program, SBA should define acceptable performance. (See our discussion of program goals in ch. 3.) After weighing the relatively few borrowers who established lasting businesses against (1) the larger number who defaulted on their loans or left business after repaying them, (2) the absence of a growth pattern for the remaining businesses, and (3) high Federal losses, it seems reasonable to us to conclude that the program's results are unsatisfactory and that attempts should be made to improve them.

### CHAPTER 3

#### REASONS FOR HIGH RATE OF

#### BUSINESS FAILURE AND PROGRAM LOSSES

The EOL Program has produced relatively few lasting businesses for a variety of reasons, some inherent in the program's nature, others related to the way in which it has been managed and operated. From a review of a random sample of 150 EOLs approved in fiscal years 1976 through 1978 at SBA's New York, Chicago, and Los Angeles district offices, and from other sources, we identified a number of factors which contributed to the loan losses and business failures. These factors, grouped under two broad headings, are as follows:

- The EOL Program involves high-risk lending because of the purpose and design of the program and the business handicaps faced by borrowers.
  - The EOL Program lends to businesses that are unable to qualify for bank and 7(a) loans.
  - Available data indicates that small businesses in general may have a high termination rate.
  - Many borrowers are inexperienced and under-capitalized.
  - Borrowers' businesses are in disadvantageous locations.
- Program management and operation have been deficient in some respects.
  - SBA loan officers have not adequately examined loan applicants' qualifications and the appropriateness of loan amounts:
  - SBA's goals system is incomplete, focusing efforts on lending in quantity but not on lending effectively. Goals have been established for making a certain volume of loans but not for creating successful businesses. In addition, SBA has been inattentive to program results by not determining the number of lasting businesses the program has produced.

--SBA has adopted a first-come, first-served lending policy for direct loan applicants meeting the minimum credit standards, which permits less-qualified applicants to receive loans at the expense of better qualified applicants.

We sampled 50 loans at each of the three offices where we did this phase of our review. 1/ The status of these 150 loans as of October 31, 1979, was as follows.

	<u>Number</u>	<u>Percent</u>
Current	<u>a/66</u>	44
Past due (31 to 60 days late on payments)	7	5
Delinquent (over 60 days late on payments)	20	13
Deferred	4	3
In liquidation	17	11
Charged off	25	17
Paid in full	<u>b/11</u>	<u>7</u>
Total	<u>150</u>	<u>100</u>

a/Includes 12 loans which had been deferred previously.

b/Includes 6 loans paid in full by refinancing.

THE EOL PROGRAM SERVICES  
A HIGH-RISK CLIENTELE

EOLs are "last resort" loans

The EOL Program's legislative history makes clear that SBA was expected to take greater lending risks in the EOL Program than in its 7(a) loan program. SBA's policy is that if a disadvantaged loan applicant can qualify for the 7(a) program, the loan should be made under that program rather than the EOL Program. A borrower of a direct EOL (almost 68 percent of all EOLs approved through September 30, 1979, were direct loans) must be denied a loan by two banks, 2/ including his or her own bank, and be found unqualified by SBA for a 7(a) loan. A guaranteed borrower must be turned down by a bank and be unqualified for participation in the 7(a) program.

---

1/Additional details on this sample are presented in chapter 6.

2/A borrower in a city with a population under 200,000 need only be turned down by his or her own bank.



SBA's standard operating procedures governing loan-making state that "The credit criteria for EOLs are liberal and will involve the taking of calculated risks. Every effort should be made to find a basis for approval."

Termination rate for  
small businesses generally

In order to put the business survival and loan default rates of EOL borrowers in perspective, we reviewed available data on these rates for other small businesses.

There is some evidence that most small businesses are short lived. A 1979 study of job creation entitled "The Job Generation Process," 1/ prepared for the Department of Commerce's Economic Development Administration, found that 57.8 percent of firms listed in Dun and Bradstreet records with 20 or fewer employees terminated in the 7-year period 1969 to 1976.

On the other hand, the failure rate of small business borrowers is much lower. Using data prepared by Dun and Bradstreet, Inc., the Minority Business Development Agency, Department of Commerce, estimated that in 1978, 1.2 percent of its client businesses discontinued operations with loss to creditors, as compared to 0.2 percent of a group of small business nonclients, selected for comparative purposes. 2/ The business termination rate for 7(a) borrowers is also much lower than the Economic Development Administration study's estimate. As is indicated in chapter 2 of the report, only 18 percent of the borrowers who left that program through May 1979 defaulted on their loans. The other 82 percent remained in business at least long enough to repay their loans, a process that takes 8 years on the average.

---

1/"The Job Generation Process," David L. Birch, M.I.T. Program on Neighborhood and Regional Change, Cambridge, Mass. The study was in draft as of August 1980.

2/These statistics are for a 1-year period and so are not directly comparable to the statistics presented in the Economic Development Administration's study.

Many sampled borrowers were inexperienced and had low personal investment

According to information in their loan files, most sampled borrowers at the three district offices we visited were mature, reasonably well-educated people with substantial employment histories. Most had moderate incomes. Most were at least 39 years old when their loans were approved. 1/ Seventy-nine percent were at least high school graduates, and 20 percent had college degrees. 2/ Fifty percent of borrowers reported family incomes of at least \$10,900 on their loan applications; almost 20 percent reported family incomes exceeding \$20,000. 3/

On the other hand, most borrowers lacked managerial experience and capital and were opening businesses or had recently started them when their loans were approved. SBA officials cited inexperience and undercapitalization as causes of borrowers' failure. About half of our sampled borrowers

--did not have managerial experience in the same kind of business they started or bought,

--owned businesses which had been in existence for less than 14 months when their loans were approved, 4/ and

--had less than \$15,000 invested in their businesses. (A fourth had less than \$6,000 invested.) 4/

Sampled EOLs were generally made to small retail or service operations. Half of the businesses already established at the time their loans were approved had fewer than two employees, less than \$52,600 in annual sales, less than \$6,024 in net income, and net worths of less than \$15,800. 5/

---

1/Based on information for 144 of 150 sampled borrowers.

2/Based on information for 149 of 150 sampled borrowers.

3/Based on information for 140 of 150 sampled borrowers.

4/Based on information for 146 of 150 sampled borrowers.

5/Ninety-three sample loans were made to already existing businesses. Data was available for 92 of these loans on number of employees and for 73 loans on sales, net income, and net worth.

Ironically, as measured by their family incomes, borrowers who were not yet in business when their loans were approved were better off economically than those who were already in business. About half of the borrowers who had been in business more than 2 years when their loans were approved had family incomes of less than \$9,800, 1/ while borrowers who were starting businesses had family incomes averaging about \$14,612. 2/

Because it was dissatisfied with the results of its efforts to assist firms of the very small size of most of our sampled borrowers, the Minority Business Development Agency restricted assistance, beginning in fiscal year 1979, to firms with actual or projected sales of at least \$150,000 or with at least five employees.

#### Limited markets

In addition to inexperience and inadequate capital, many EOL borrowers are hampered by their locations. As the maps on pages 28 and 29 indicate, sampled EOL borrowers in New York and Chicago were concentrated in the poorer areas of their cities. 3/

According to a study of minority business prepared for the Department of Commerce ("A New Strategy for Minority Business Enterprise Development," by James H. Lowry and Associates, April 1979):

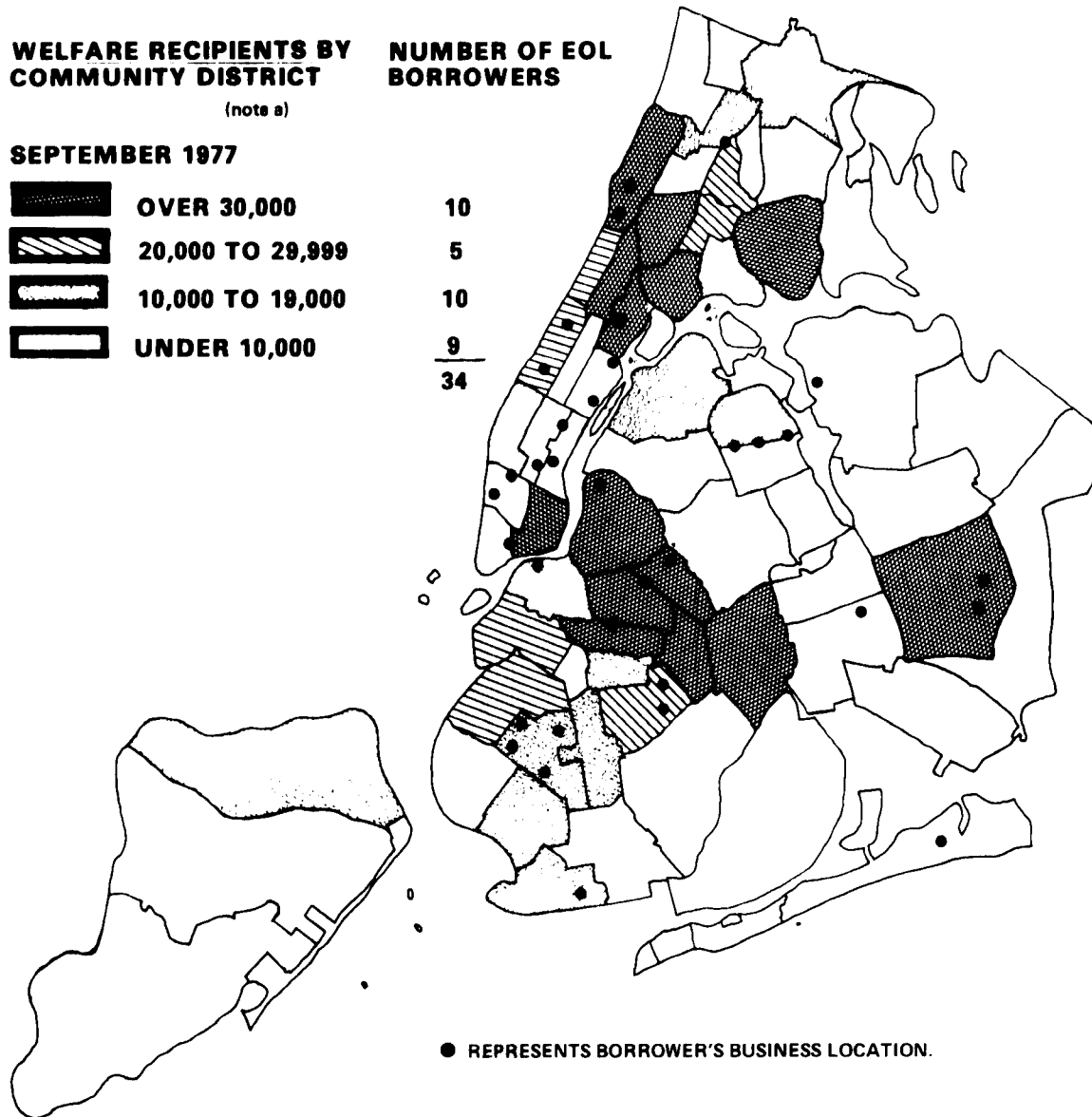
---

1/Based on information for 59 of 62 sampled borrowers who had been in business for more than 2 years.

2/Based on information for 52 of 56 new businesses.

3/Sampled borrowers not shown on the maps were located outside the New York or Chicago city boundaries. A similar map for Los Angeles borrowers was not readily available.

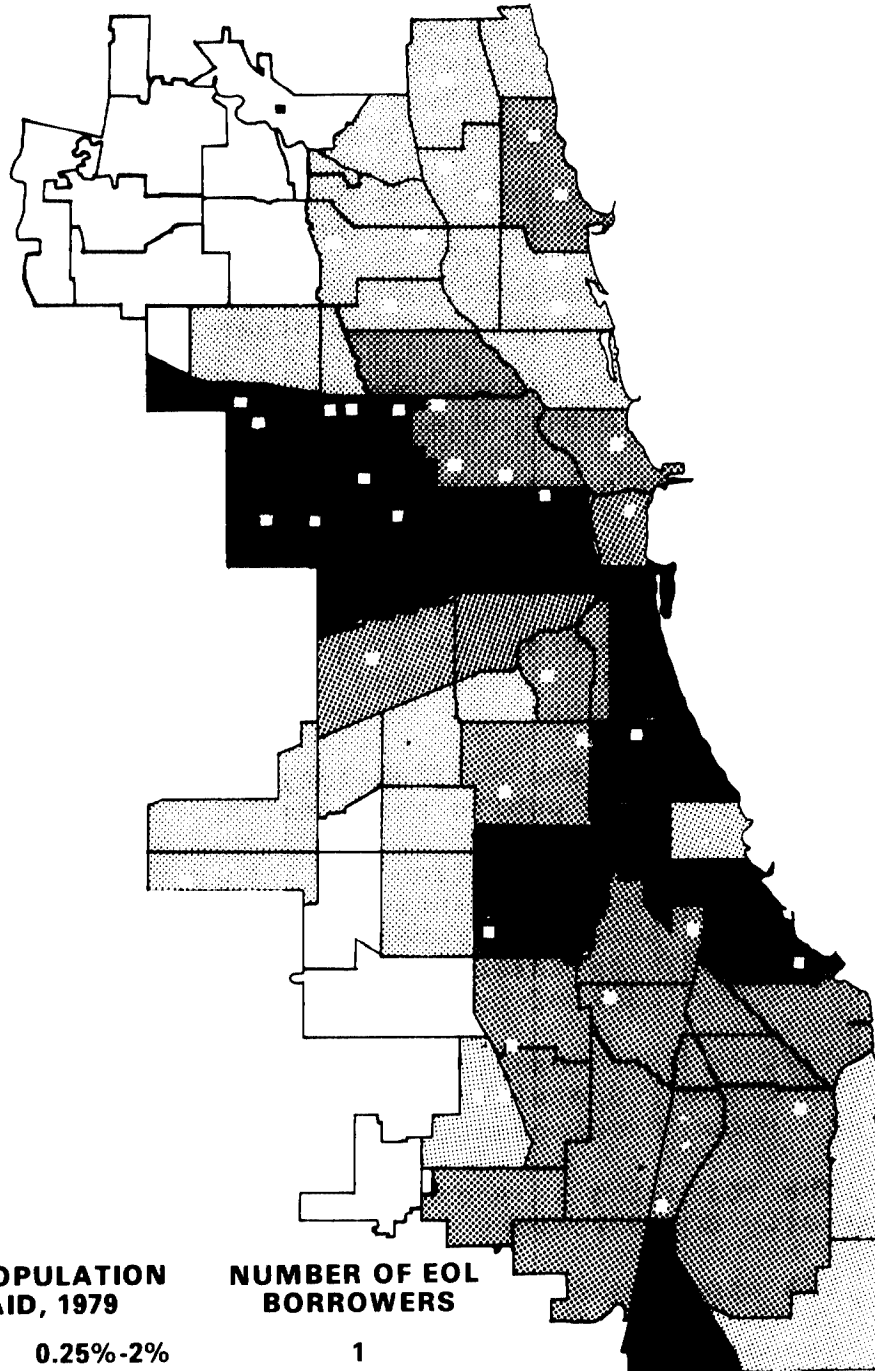
# LOCATION OF SAMPLED EOL BORROWERS IN NEW YORK CITY



(a) Community districts are geographic units used by the New York City government for planning public services and investment.

SOURCE: Adapted from a New York City Community Development Agency study "The Neighborhoods of Poverty", Nov. 1978.

# LOCATION OF SAMPLED EOL BORROWERS IN CHICAGO



**PER CENT OF POPULATION ON PUBLIC AID, 1979**



0.25%-2%  
2%-10%  
10%-30%  
30%-50%  
**MORE THAN 50%**

**NUMBER OF EOL BORROWERS**

1  
11  
16  
12  
1  
41

□ REPRESENTS BORROWER'S BUSINESS LOCATION.

SOURCE: Illinois Department of Public Aid data analyzed by Chicago Area Geographic Information Study, University of Illinois at Chicago Circle, adapted from a map prepared by *The Chicago Reporter*.

"The bulk of [minority-owned] firms are located in the inner cities of the West, Midwest and Northeast. These locations, with rare exceptions, have high levels of unemployment and welfare, high crime rates, and deteriorating neighborhoods. In the distressed areas of Chicago, where over 90 percent of the City's [minority-owned businesses] are located, there is:

- 14.6 percent unemployment as compared to 7.1 percent [in other areas];
- 45.0 percent youth unemployment as compared to 22.0 percent [in other areas]; and
- \$8,369 median income as opposed to \$11,138 [in other areas]. 3/

"Operating a small business is difficult under the best of conditions, but for the minority business person to survive in the inner city represents an almost unachievable dream. The Reuss Subcommittee on the City, of the [House] Committee on Banking, Finance, and Urban Affairs highlighted the following barriers to retaining or expanding operations in these locations:

1. Limited availability of land;
2. Poor public services;
3. Crime;
4. Overregulation;
5. Perceived anti-business attitude of Local Government;
6. High taxes; and
7. Lack of an adequate labor supply.

"3/City of Chicago, Community Development Block Grant Proposal to the Department of Housing and Urban Development, 1977."

The following is a case from our sample of the problems inner-city EOL borrowers face.

SBA approved a \$15,000 loan to a body and fender shop in Chicago. The borrower, who did not have previous managerial experience, located his shop in a deteriorating area with a declining population and high crime rate. The shop was burglarized frequently. SBA provided the borrower with management assistance in September 1976. The counselor suggested that the borrower relocate his shop because of limited sales potential and continual thefts. In 1977 the borrower ceased operations and abandoned his shop.

Another indication of the importance of location to a small business' prospects for success is contained in a manual describing the Neighborhood Business Revitalization Program, a multiagency effort to strengthen the economic base of cities. 1/ This manual states that:

"In developing a commercial revitalization program, you will not have any real impact if you only work with isolated businesses scattered across the city."

\* \* \* \* \*

"The success of a commercial strip and the economic success of the individual small business on that commercial strip depend upon the stability and purchasing power of the surrounding neighborhood. If a neighborhood is too deteriorated or if a neighborhood contains too heavy a concentration of unemployment, the chances of success are substantially reduced."

#### DEFICIENCIES IN PROGRAM MANAGEMENT AND OPERATION

Given the program's mandate for high-risk lending and the disadvantages that EOL borrowers operate with, it is likely that even with flawless management, program losses and the rate of borrower failure would be high. However, the management and operating deficiencies discussed below have contributed to the program's low yield.

#### Qualifications and needs of borrowers not fully analyzed

SBA loan officer reports, upon which the decision to approve or reject a loan application is based (and which SBA procedures say should normally be so comprehensive that a reviewing official could take final action without referring to supporting documents), often did not show evidence of careful analysis of certain elements of borrowers' qualifications and needs. According to SBA's loan approval procedures,

---

1/"Neighborhood Business Revitalization," prepared by The National Development Council, Washington, D.C.

"The professional Loan Officer recognizes the intent to accept higher risk and weaker credits under the Agency's policies. This intent is not interpreted as an excuse to ignore analysis, but, rather, recognition that careful analysis is important."

\* \* \* \* \*

"While the quality of a credit decision must be emphasized, it is not intended that this necessarily be translated into a demand for stronger credit or fewer loan approvals. While we cannot defend a policy of irresponsible lending, we can accept liberal credit decisions provided that we recognize all factors involved in the decision.

"Financial assistance can only be helpful to those firms that have a reasonable chance for success. That 'chance' can only be determined by an adequate analysis of the total loan application."

From our review of 150 sampled loans at three district offices, we found that loan officers' analyses were often deficient in the areas of 1/

- examining applicants' sales and expense projections,
- analyzing applicants' anticipated cash flow,
- evaluating applicants' management abilities, and
- considering the appropriateness of the loan amount.

#### Analysis of projections

SBA procedures instruct loan officers to carefully review applicants' earnings projections. This analysis is especially important in the EOL Program since so many of the businesses are new and there is little historical data on which to make an assessment of future performance.

Yet, we found that loan officers had not analyzed borrowers' sales projections for 56 percent of the loans

---

1/The percentages derived from this sample would have a maximum sampling error of plus or minus 8 percent at the 95 percent confidence level.



we sampled and had not analyzed expense projections in 83 percent of the cases. 1/ This was true also for loans that were charged off or in liquidation. The sales projections of 60 percent of these borrowers and the expense projections of 87 percent were not examined.

The need to carefully review earnings projections is pointed out by the results of a comparison we made of the projections of sampled borrowers whose loans were charged off or in liquidation, with actual earnings of other small firms in the same industries. To make this comparison we used data obtained from Robert Morris Associates' (RMA) 1978 "Annual Statement Studies," a reference widely used in the banking industry to evaluate credit applications. According to SBA's loanmaking procedures manual, the RMA figures (and other statistical compilations) "are useful to the Loan Officer and the applicant to compare the operation and financial condition of a business against industry averages."

"Annual Statement Studies" contained earnings figures for industries in which 32 of the charged-off or in-liquidation borrowers were located. Twenty-three of these borrowers had projected that their rate of profit on net worth would be higher than the most profitable small firms in the same industries. On the other hand, the borrowers' projected sales were generally in line with industry averages. 2/ In other words, borrowers were estimating that they would earn more on the same sales than other small firms. They could do this only by having lower expenses. As stated above, loan officers did not analyze the expense projections of 87 percent of the borrowers whose loans were charged off or in liquidation.

The following is a case from our sample of a loan whose projections should have been fully analyzed.

Two Chicago area borrowers gave up employment providing a total of \$36,000 a year in salaries to buy a wholesale porcelain and clay products business. Pooling savings of \$6,000 and using the proceeds of a \$20,000 direct EOL approved in June 1976, they paid \$8,000 for the existing business' equipment and used the remainder for improvements, new equipment, and working capital. SBA did not perform a critical appraisal of the borrowers' sales and expense projections prior to loan approval.

---

1/This statement is based on 147 sampled borrowers.

2/More details on the comparison are shown in appendix IV.

Business was not as good as the borrowers predicted. They missed their second loan payment and were granted a 6-month deferment and a reduction in payment size. The borrowers told SBA that sales were poor and complained of expenses related to problems with the building in which their business was housed. The borrowers were able to make 11 payments before they stopped paying in May 1978. SBA charged off the loan balance plus accrued interest in July 1979 for \$20,791.

### Analysis of cash flow

Loan officers did not analyze loan applicants' anticipated cash receipts and disbursements for 64 percent of all sampled loans (76 percent of the sampled loans charged off or in liquidation), even though SBA procedures say that "the ability to repay a loan from the cash flow of the business \* \* \* is the most important consideration in the loan making process."

The following is a case from our sample of a borrower whose prospective cash flow should have been carefully examined.

In July 1975, a \$20,000 direct EOL was approved to help two Chicago borrowers sell security systems in high crime areas. Sales were good, but the borrowers extended liberal financing terms to their customers. This strained their cash flow and they were unable to sell their accounts receivable. The borrowers made only three payments before the loan was put into liquidation in September 1976. No cash flow analysis was performed prior to loan approval, and SBA therefore was not in a position to anticipate these problems.

### Consideration of sufficiency of loan amounts

SBA's standard operating procedure on loanmaking also emphasizes the importance of analyzing the appropriateness of the loan amount approved for an applicant, but the reports prepared by loan officers recommending approval of loans did not usually show evidence of any such analysis, nor is an analysis required. The procedures say that:

"The professional Loan Officer recognizes that a loan application is more than simply a request for money. In a broad sense, it is a statement of a business problem (usually financial) and a proposed solution to that problem. The professional Loan

Officer will determine, first, if the problem has been correctly identified. If not, it must be identified.

"Next, it must be determined if the proposed solution (the loan request) is the correct solution. If not, the proper solution will be proposed."

\* \* \* \* \*

"If a loan request does not provide for adequate working capital, consideration should be given, if feasible, to increasing the loan. Many loans are in liquidation solely because working capital requirements were not given adequate consideration."

In addition, a condition for loanmaking according to the procedures is that "The amount of the loan, together with other available resources, is adequate to achieve the purpose for which the loan is made."

Nevertheless, SBA procedures do not explicitly require loan officers to document in their reports their consideration of the appropriateness of loan amounts. In our opinion, the reports should contain such an analysis to focus loan officers' thinking and provide a basis for supervisory review of this subject. We found that reports for 78 percent of sampled loans contained no analysis of loan sufficiency (77 percent for loans charged off or in liquidation).

Because EOLs are usually such small loans, attention to the adequacy of their amounts would seem especially important. Most direct EOLs approved in fiscal year 1978 were for \$22,000 or less; most guaranteed EOLs were approved for \$25,000 or less. <sup>1/</sup> The median amounts of 7(a) direct and guaranteed loans in fiscal year 1978 were almost double these EOL figures. Fifty percent of our sampled loans authorized less than \$8,100 for working capital. In addition, most borrowers we talked to about the management assistance they received from SBA, said that they did not have the financial resources to carry out half or more of the recommendations made by management counselors. (See ch. 4.)

---

<sup>1/</sup>The average amount of direct EOLs approved in fiscal year 1979 was \$33,058; guaranteed EOLs averaged \$39,766. Median figures for fiscal year 1979 comparable to those shown above for 1978 were not available.

According to a Los Angeles banker we interviewed, many loans are made to borrowers who did not ask for enough money. The chief of the Financing Division at one of the district offices we visited said that loan applicants are likely to agree with a lesser amount even when they might feel it is insufficient, believing that some money is better than no money.

The following is a case from our sample illustrating the need for loan officers to consider the adequacy of the loan amount approved. The case is not intended to prove that the borrower would have succeeded with a larger loan.

A Los Angeles area borrower requested a \$75,000 loan to open an American-Indian jewelry and handicrafts store in a major shopping center. Acting on advice from SBA officials, the borrower sharply lowered the requested amount and in June 1976 received a loan of \$37,000--less than half the amount he originally felt he needed. The borrower's personal investment was \$21,500, which included inventory and equipment from a previous business and some cash obtained by refinancing his home.

The loan officer in the case had analyzed the borrower's projections, comparing them to Robert Morris Associates' industry averages, and had revised them to fall within more realistic expectations. He concluded that the "Projection, thus adjusted, shows adequate cash flow to repay the loan, with a small margin left over." However, his report did not show that he had considered whether the loan amount would carry out the borrower's plans for his business. In April 1977 the borrower requested a 6-month deferment of his payments, and SBA and bank officials agreed that management assistance was needed. An SBA loan assistance officer visited the borrower and noted his lack of business and difficulty in making payments. A call contractor was sent out by SBA in May. This contractor reported that the store had been unprofitable and undercapitalized "since opening its doors."

The loan became delinquent in May 1977. In August 1977 the borrower asked for but was denied additional funds. By March 1978 he was evicted from the shopping mall in which he operated. The loan was charged off in October 1979 for \$44,479. The

borrower had invested most of his personal assets in the business when the loan had originally been approved and had given up a \$21,000-a-year job to start the business. He was discharged in bankruptcy in May 1979. He had these comments about his experience:

"I was completely dissatisfied with the SBA \* \* \* and \* \* \* [the] bank. I had originally asked for \$75,000 but was told by SBA \* \* \* to only ask for \$37,000. My wife and I said that we needed much more money, but they said no. I know now I shouldn't have let them give me only \$37,000. I should have refused the \$37,000.

"After I found the \$37,000 was not enough (about 3 months after disbursement) I tried to contact SBA \* \* \* and the bank to increase the amount. \* \* \* They all refused \* \* \*. [SBA] should not have allowed me to only take \$37,000."

Borrowers' management ability  
not evaluated

SBA procedures provide for two techniques for evaluating a loan applicant's management ability: (1) a preloan approval visit to the applicant's business by a loan officer and (2) a management evaluation by a representative of the district office's management assistance division. Both of these techniques were often not used at the district offices we visited.

According to SBA procedures,

"The capability of management is a critically important factor in the loanmaking function. It would be difficult to assess [without] the benefit of a visit to the applicant's business. While the opinion of the bank or the [Assistant District Director for Management Assistance] is taken into consideration, it must be remembered that management analysis is a basic part of the loanmaking decision, and must be carefully evaluated and commented upon by the Loan Officer."

Field visits to the borrower's business are required by SBA procedures on all direct loans, unless waived by supervisory officials. They may be made on guaranteed loans at the discretion of the loan officer. Loan officers did not make a field visit before loan approval on 43 percent of the

sampled loans. They did not visit borrowers of 26 percent of the direct loans and 83 percent of the guaranteed loans.

SBA procedures also require that an appraisal of the management abilities of all direct EOL applicants be made by the district office's management assistance division. This division is to certify to the loan officer considering the loan request whether the applicant (1) can manage his business successfully, (2) cannot manage it successfully, or (3) can manage successfully if a specified management assistance program is completed. The loan processing officer is required to consider the management assistance division's conclusion before recommending final action on the loan application. Disbursement of the loan may be withheld until the loan applicant has completed the recommended management program.

We found that this evaluation was not performed for 52 percent of the direct loans we sampled.

An Assistant District Director at one of the offices we visited said that no system had been set up to ensure that all direct loan applicants received a management evaluation. Moreover, he said that about three-fourths of the evaluations are made in the SBA office, not at the borrower's business.

The following is a case of a sampled borrower whose management ability should have been determined through a management evaluation before a loan was approved.

SBA approved a \$20,400 direct EOL in January 1977 to a Los Angeles borrower to open a restaurant. No preapproval management evaluation was performed. Within 2 months of the first loan disbursement, a SCORE counselor 1/ paid a visit to the business and observed that the borrower was having problems with pricing, sales, and organization. According to the counselor, the borrower seemed to have too many employees and employee training was lax. Several days later, the SCORE representative noted that "the guy just doesn't seem to be able to get it all together." The borrower regarded the SBA management assistance as a bother and felt that he knew what he was doing. A SCORE representative

---

1/See chapter 1 for a description of SBA's management assistance programs.

visited again in about 4 months and noticed a lack of business. On September 12, 1977, the loan was placed in liquidation when the borrower was evicted from his business location. No payments had been made on the loan. SBA cited extensive confusion and high labor costs as reasons for borrower failure. The loan balance and accrued interest of \$21,732 was charged off in March 1978.

Few payments made on loans  
charged off or in liquidation

The need for a complete credit analysis to screen out unqualified applicants is underscored by the payment records of borrowers in our sample whose loans were charged off or in liquidation. Most of these borrowers encountered serious business problems early in the course of their loans, as evidenced by the fact that most made few or no payments up to the time their loans were put into liquidation.

We could obtain payment records for 33 of the 42 sampled loans which were charged off or in liquidation. The number and amounts of payments made by the 33 borrowers before their loans were placed in liquidation, their approved loan amounts, and the amounts owing at liquidation are shown in the following table. 1/

---

1/Borrowers may have made some payments after their loans were placed in liquidation. But records we examined did not distinguish such payments from amounts realized by liquidating the business. In total, \$51,844 was collected on these loans after they were placed in liquidation.

Number and Amounts of Payments Made by  
33 Sampled Borrowers

Number of repayments (note a)	Amount of repayments (note a)	Loan amount approved	Balance at liquidation (note b)
0	\$ 0	\$ 85,000	\$ <u>c</u> /85,000
0	0	20,000	20,851
0	0	15,000	15,186
0	0	10,000	<u>c</u> /10,000
0	0	10,000	10,371
0	0	20,400	20,829
0	0	49,480	<u>d</u> /52,467
1	200	20,000	21,571
2	3,104	50,000	48,518
2	610	15,000	15,027
2	2,770	35,000	33,781
3	387	20,000	20,150
3	104	5,500	5,515
3	1,401	38,000	37,460
3	451	20,000	<u>d</u> /21,728
4	707	35,000	35,438
4	1,283	40,000	40,245
4	968	12,000	<u>c</u> /11,406
6	5,948	95,000	94,788
6	571	10,000	10,229
7	3,035	50,000	<u>e</u> /57,121
7	1,014	23,000	23,518
8	3,703	25,553	24,407
8	4,448	50,000	<u>c</u> /48,011
11	5,024	50,000	<u>c</u> /48,490
11	3,699	20,000	19,082
11	429	6,500	6,499
13	4,480	30,000	33,216
13	8,487	100,000	96,951
15	5,360	35,000	37,488
16	5,415	19,000	<u>c</u> /16,053
20	12,020	38,000	<u>d</u> /33,277
28	22,553	30,000	<u>d</u> /12,380
<u>211</u>	<u>\$98,171</u>	<u>\$1,082,433</u>	<u>\$1,067,053</u>

a/Includes partial payments.

b/Includes accrued interest except where otherwise noted.

c/Principal only.

d/Loan was charged off without being placed in liquidation.

Number and amount of payments shown are through charge off.

Loan balance at liquidation represents amount charged off.

e/Second time in liquidation. Payments include those made up to the time the loan was put into liquidation the second time.



As the table indicates, seven borrowers did not make any payments before their loans were placed in liquidation. Eighteen made four or fewer payments.

The average amount of the loans was \$32,801; repayments up to liquidation averaged \$2,975 per loan; the average loan balance at liquidation was \$32,335. 1/

Goals do not direct the program toward producing successful businesses-- program achievements not measured

SBA has goals for the EOL program which encourage (1) the commitment of all available direct loan funds to assist disadvantaged and low-income people and (2) increased bank lending in the guaranteed segment of the program. But no goals have been established for creating or expanding successful businesses, nor have the achievements of the program in these areas been regularly measured.

In our view SBA's lack of goals for producing successful businesses is a major reason why loan officers have not carefully analyzed the qualifications and needs of loan applicants. According to the District Director at one of the offices we visited, under the present system loan officers feel more pressure to make many loans than to make good loans. SBA's Internal Audit Division reported in 1976 that EOLs were being approved even though applications "did not show adequate potential for repayment ability from profits of the business." 2/ The internal auditors said that

"the emphasis placed on quantity rather than quality has greatly contributed to this condition. The result has been inadequate evaluation of factors affecting repayment ability, and nonrecognition and/or identification of the risks associated with approvals."

The case for the establishment of goals to direct the EOL Program toward producing successful businesses rather

---

1/Liquidation had been completed on 21 of the loans. The approved amount of these loans averaged \$21,804. The average amount charged off on the loans including accrued interest was \$21,026.

2/"Report of Audit on a Review of the Economic Opportunity Loan Program," June 18, 1976. The Internal Audit Division is now known as the Office of Internal Audit, Office of the Inspector General.

than a maximum quantity of loans, is well stated by SBA's standard operating procedure on loan approval.

"From a socioeconomic viewpoint, the indiscriminate approval of loans at a high volume and low rate of success can do nothing but impair our relationship with the small business concerns and communities that we are attempting to help. When a loan is made with little or no chance of success and the business subsequently fails, not only has the borrower been burdened with a substantial debt which cannot be repaid but the entire community has been given cause to question our judgment and create a lack of confidence in us to the detriment of our programs in that community, as well as in others throughout the country."

First-come, first-served lending to all applicants meeting minimum standards can result in less-qualified applicants receiving loans before better qualified applicants

The demand for direct loan funds far exceeds their supply at most SBA district offices. In the interest of fairly allocating these funds, SBA has adopted a system of making direct loans on a first-come, first-served basis. Direct loan applicants are placed on a waiting list after their applications are screened for basic eligibility. Applicants receive loans in accordance with their position on the waiting list as loan funds become available.

According to SBA procedures:

"A chronological [waiting] listing shall be kept of applicants for direct loans whose applications are returned by the office due to lack of direct funds. Whenever the office determines to accept additional direct loan applications, such applicants shall be notified, in chronological order, that they may file, or refile returned applications within a reasonable period of time. This should insure that applicants for direct funds are not taken out of order when funds do become available."

The New York and Los Angeles district offices were using these waiting lists at the time of our review. The chief of the Financing Division at the Chicago district office said that the office was able to deal with requests for direct loans without resorting to waiting lists. Waiting lists are not maintained for guaranteed loan applications because funding constraints do not require them.

Applicants for both EOL and (a) direct loans are placed on the lists.

Enormous backlogs have developed on the waiting lists at some district offices. Applicants were waiting up to 14 months in Los Angeles and 9 months in New York. According to an official of SBA's Office of Small Business Loans, delays of up to 2 years existed in some district offices. According to the chief of the Financing Division at one office we visited, the situation was "out of hand."

SBA officials in the Office of Small Business Loans, Office of Portfolio Management, and the district offices we visited said that one of the drawbacks of the waiting list was that less-qualified applicants could receive loans at the expense of better qualified applicants who were farther down on the lists. According to a supervisory loan officer of the Financing Division at one office, only about half of the applicants on the waiting lists resubmit their applications when recalled by SBA. Many well-qualified applicants may lose their opportunity to continue in business or to start a business because of waiting list delays.

Whatever the merits in the 7(a) program of making loans on a first-come, first-served basis to applicants meeting the minimum credit standards, we believe it is not appropriate for the EOL Program, whose lower credit standards make the issue of the applicants' ability to repay more critical. SBA should accept on its waiting lists only that number of best qualified EOL applicants who can be funded within a reasonable time.

### CONCLUSIONS

The EOL Program by purpose and design involves high-risk lending. It services borrowers who cannot get assistance from other SBA programs and who are disadvantaged by inexperience, low capital investment, and poor business locations. Because of these factors, rates of loss and business failure higher than in other Federal business lending programs are probably unavoidable. However, certain deficiencies in SBA's management and operation of the program have contributed to its high loss rate and limited output of successful businesses. These have included

- inadequate analysis of the needs and qualifications of loan applicants;
- the fact that SBA has not (1) set goals which direct resources toward producing successful businesses or (2) measured what the program is achieving; and

--a policy of funding, on a first-come, first-served basis, EOL applicants who meet the minimum credit standards.

In our view, SBA's establishment of goals to encourage the maximum possible lending without any goals for producing successful businesses has contributed to the deficient credit analyses made by loan officers.

#### RECOMMENDATIONS TO THE SBA ADMINISTRATOR

To improve the effectiveness of the program as a vehicle for the economic advancement of disadvantaged people and to reduce unnecessary losses, we recommend that the Administrator, SBA:

- Require more comprehensive examinations by loan officers of the prospective borrowers' ability to repay and financing needs, including better analyses of projections, anticipated cash flow, management capability, and the sufficiency of loan amounts. SBA procedures should be revised to explicitly require loan officers to address the issue of the appropriateness of loan amounts in their reports on loan applications.
- Establish program goals for producing successful, lasting businesses and monitor the progress of the program toward reaching these objectives.
- Upgrade minimum credit standards for the program so that only the best qualified EOL applicants who can be funded within a reasonable time are admitted onto the waiting lists.

#### SBA COMMENTS AND OUR EVALUATION

SBA said it doubted that "a vigorous review of high risk situations would significantly affect the program output performance."

In our view, better credit analysis of loan applicants would (1) screen out applicants who do not have a reasonable chance of repaying the loan and (2) ensure that the best qualified applicants are funded.

SBA did not disagree that goals for producing successful businesses were needed but questioned the short-term impact of such goals. We agree that the full effects of EOLs on

borrowers could not be determined for some time, but believe that this is not an adequate reason for not establishing any goals. In addition, some results, such as change in the loan delinquency rate, would become quickly apparent.

SBA agreed with our recommendation for changing its waiting list system.

## CHAPTER 4

### ATTEMPTS TO ASSIST EOL BORROWERS

#### HAVE BEEN INEFFECTIVE

The Small Business Act authorizes special treatment of EOL borrowers to improve their chances for success. Section 7(i)(1) of the act says that:

"The Administration may defer payments on the principal of \* \* \* loans for a grace period and use such other methods as it deems necessary and appropriate to assure the successful establishment and operation of [borrowers]. The Administration may in its discretion, as a condition of \* \* \* financial assistance, require that the borrower take steps to improve his management skills by participating in a management training program approved by the Administration: Provided, however, That any management training program so approved must be of sufficient scope and duration to provide reasonable opportunity for the individuals served to develop entrepreneurial and managerial self-sufficiency."

The SBA district offices we visited have employed a number of techniques to relieve borrowers' undercapitalization and mitigate their inexperience. These have included

- limited grace periods on initial loan repayments,
- liberal use of deferments,
- refinancing of troubled loans, and
- management assistance.

Refinancing and deferments have not been effective for most sampled borrowers who were having trouble repaying their loans. The value of grace periods and management assistance in improving borrowers' chances for success has not been established because their use has been too limited.

SBA field offices have made little, if any, use of another technique authorized by SBA procedures to assist borrowers: graduated repayment schedules with lower payments in the early years of the loan, increasing in later years when the borrower may be more firmly established in business.

GRACE PERIODS AND GRADUATED REPAYMENT SCHEDULES  
HAVE BEEN UNDERUSED ASSISTANCE TECHNIQUES

SBA procedures for the EOL Program state that:

"Every attempt should be made in applicable cases to establish as liberal a grace period on principal payments as possible to not only insure the repayment of the loan but, more important, for the ultimate success of the business. Interest payments, however, should be made as soon after [the] loan is disbursed as possible. Smaller payments may be established for the early years, either instead of or in conjunction with grace periods, and increased in later years. \* \* \* This being a loan program for the 'disadvantaged' there should be room for realistic loan conditions that would allow for some 'advantages' to the borrower."

Despite this encouragement, borrowers of sampled loans were not usually given extended grace periods. According to officials of SBA's Accounting Operations Division and Office of Small Business Loans, graduated repayment schedules are seldom, if ever, used.

Fifty-nine percent of our sampled borrowers were required to begin paying interest on their loans within about 1 month (31 days) of the initial disbursement of their loans. 1/ Principal repayments were required for about half of the borrowers within 3 months (91 days). 1/ Even borrowers who were starting out in business were not usually granted extended grace periods. Sixty-three percent had to begin paying interest within 31 days and half had to start repaying principal within 92 days. 2/

---

1/Percentages based on 149 of 150 sampled borrowers for whom information was available.

2/The time intervals shown above are based on the scheduled date of initial payments stated in SBA loan documents and may not represent the actual time between loan disbursement and the date the borrower made his first payment.

District office officials told us they believed that borrowers ought to be required to begin loan repayments early to establish a payment-making habit and that if a borrower needed relief from loan payments, this could be achieved by way of a deferment. At the same time, an Assistant District Director at one of the offices we visited acknowledged that by the time a borrower requested a deferment he or she might already be in serious trouble. This is borne out by our sample. About two-thirds of sampled borrowers who received a deferment were delinquent when their first deferment was granted. Their delinquencies averaged over 4-1/2 months.

The value of extended grace periods on principal repayments, as a means of stimulating business growth, is recognized by another SBA program, the Small Business Investment Company Program. These companies can qualify for special Federal funding by providing "venture capital financing" to small businesses. According to SBA regulations, venture capital financing includes loans which do not require principal repayment for the first 3 years.

Officials of SBA's Office of Small Business Loans and Office of Portfolio Management believed that graduated repayment schedules were infrequently used because they were more difficult administratively for SBA. On the other hand, officials conceded that new businesses commonly have severe cash flow problems and need to reinvest what cash is generated until they get on a firmer footing. As indicated in chapter 3, about half of the sampled borrowers owned businesses which were less than 14 months old at loan approval.

DEFERMENTS HAVE NOT SAVED MOST BORROWERS

SBA district office officials said that payment deferments were liberally granted. Fifty-three of the 150 loans we sampled had been given deferments; 19 had received more than one. The following table shows the number of borrowers who received the indicated number of deferments.

Number of deferments <u>granted</u>	Number of <u>loans</u>
1	34
2	14
3	3
4	<u>2</u>
Total	<u>53</u>



Most deferments were for 5 months or more. They ranged up to 18 months. 1/

Deferments have been an inadequate tool for improving borrowers' businesses. Forty-nine borrowers had received deferments terminating before October 31, 1979. Thirty-two of these 49 borrowers had again fallen behind on payments or were charged off or in liquidation by that date.

The following table shows the loan status on October 31, 1979, of the 53 borrowers whose loans had been deferred.

<u>Loan status at</u> <u>October 31, 1979</u>	<u>Number of</u> <u>borrowers</u>
Current	12
Past due	5
Delinquent	11
Deferred	4
Charged off or in liquidation	16
Paid in full	<u>5</u>
Total	<u>53</u>

The Acting District Director at one of the SBA offices we visited told us that deferments help only with financial problems but do not cure borrowers' management problems. Deferments might aid a business which has seasonal swings in sales, this official said, but for other cases, including businesses in trouble because of poor management, deferments offer little hope.

#### REFINANCING NOT USEFUL FOR MOST TROUBLED BORROWERS

At district offices we visited, refinancing 2/ produced good results for some borrowers in the sense that the second loans were current or paid in full, but not usually for those who were in trouble when their loans were refinanced. Refinancing can be an expensive form of assistance when it does not prevent a borrower from going under. SBA procedures

---

1/Data on the length of two deferments was not available.

2/As used in this report, refinancing means the approval of an SBA loan, part or all of which is used to repay the outstanding balance of a previous SBA loan. The loan used to refinance the earlier loan can have a later maturity.

state that refinancing shall not be done "for the primary purpose of protecting an unsatisfactory existing SBA loan."

We randomly selected 61 loans which had refinanced EOLs during fiscal years 1969 through 1978 at New York, Chicago, and Los Angeles. The status of these loans as of the time of our review was as follows:

<u>Loan Status</u>	<u>New York</u>	<u>Chicago</u>	<u>Los Angeles</u>	<u>Total</u>
Paid in full	1	4	6	11
Current	5	5	16	26
Delinquent	2	3	-	5
In liquidation or charged off	<u>7</u>	<u>8</u>	<u>4</u>	<u>19</u>
Total	<u>15</u>	<u>20</u>	<u>26</u>	<u>61</u>

As the table indicates, refinancing was more successful in Los Angeles than in New York or Chicago. This may be related to the facts that (1) a smaller proportion of the loans refinanced in Los Angeles were delinquent or deferred at the time of refinancing (3 out of the 25 for which information was available) than in New York and Chicago (12 out of 30 for which information was available) and (2) loans refinanced in Los Angeles had been outstanding for a longer period (38 months on the average) than in the other cities (an average of 28 months in Chicago and 23 months in New York).

Refinancing is not an effective or economical form of assistance for faltering businesses. In our sample we were able to identify 15 loans which were used to refinance delinquent loans. Of these 15 loans, 9 were charged off or in liquidation at the time of our review, 3 were delinquent, and only 3 current. The total original balances, \$319,200, of the loans which were refinanced by loans which were later charged off, in liquidation, or delinquent had been reduced by a total of only \$10,282 when they were refinanced. These borrowers received a total of \$271,993 in additional funds through the refinancing.

MANAGEMENT ASSISTANCE HAS NOT BEEN FULLY DEVELOPED AS A TECHNIQUE FOR HELPING BORROWERS

SBA's attempts to assist EOL borrowers through management assistance have had limited effect. The effectiveness of the assistance could be increased if it were provided earlier and its scope were enlarged.

Number of sampled borrowers receiving management assistance

Most sampled EOL borrowers at the cities we visited were offered management assistance, but not all accepted it. According to the chief of the Small Business Management Training Division, there are no waiting lists for management assistance from the SCORE, SBI, and Call Contracting Programs as there are for loans.

SBA procedures require that borrowers be advised of the availability of management assistance during the first field visit made by SBA personnel after loan disbursement. According to an Assistant Director for Management Assistance and other district office officials, many borrowers refuse management assistance because they think they do not need it, believe they need only money to be successful, pride themselves on being self-sufficient, do not want a Government representative at their business, or feel they do not have the time for it.

Sixty-nine of the borrowers in our sample of 150 loans approved at SBA's New York, Chicago, and Los Angeles district offices in fiscal years 1976 through 1978 received management assistance. The status of their loans as of October 31, 1979, and the status of the loans of borrowers who did not get management assistance is shown in the following table.

Loan status at <u>10-31-79</u>	Borrowers who received management assistance	Borrowers who did not receive management assistance
Current	27	39
Past due	2	5
Delinquent or deferred	14	10
In liquidation or charged off	19	23
Paid in full	<u>a/ 7</u>	<u>b/ 4</u>
Total	<u>69</u>	<u>81</u>

a/Includes five loans which were paid in full by refinancing.

b/Includes one refinanced loan.

A larger proportion of the borrowers (48 percent) who received management assistance had loans which as of October 31, 1979, were delinquent, deferred, charged off, or in liquidation, than borrowers who did not receive management assistance (41 percent).

Effect of management assistance  
on troubled businesses

Management assistance was usually not effective in improving the condition of sampled borrowers who had a prior record of delinquency or deferment. We could obtain information on the payment status of 58 of the 69 loans before and after management assistance was provided. Thirty of these 58 had a history of delinquency or deferment before receiving management assistance. As the following table shows, management assistance most often did not improve the payment status of these troubled businesses.

Loan Status as of October 31, 1979, of 30  
Sampled Borrowers Whose Loans Were Delinquent or  
Deferred before They Received Management Assistance

<u>Loan status</u>	<u>Number of borrowers</u>
Current	8
Past due	2
Delinquent or deferred	9
Charged off or in liquidation	<u>11</u>
Total	<u>30</u>

What borrowers think about management assistance

We selected at random 154 borrowers who received SBA management assistance from among borrowers whose loans were approved during fiscal years 1976 through 1978 at SBA's New York, Chicago, and Los Angeles district offices. We talked to 110 of these borrowers about the management assistance but were unable to interview the other 44, most often because they had gone out of business and could not be located. The loans of 64 percent of the clients we were unable to talk with were charged off or in liquidation while only 8 percent of the borrowers we did question had charged-off or in-liquidation loans. Our sample, therefore, excluded borrowers who, because of their business failure, were likely to have little regard for the usefulness of the assistance.

The 110 borrowers we interviewed included 18 who received assistance from SCORE, 50 from SBI, and 66 from the

Call Contracting Program. 1/ Their reactions to the assistance were mixed. On the positive side, borrowers generally felt that

- the analyses that management assistance counselors made of their businesses were adequate,
- they understood the recommendations counselors made,
- the counselors' recommendations were at least of moderate use,
- they would probably request the assistance again, and
- they would probably recommend it to someone else.

On the other hand, borrowers had generally unfavorable comments in a number of critical areas.

- With the exception of call contractors, most felt that the counselors were less than moderately familiar with their type of business.
- Most said they did not have the financial resources to carry out half or more of the counselors' recommendations.
- Most said they implemented half or less of the recommendations.
- Most said that the assistance had no impact on their sales, expenses, net income, or number of employees. 2/

- - - - -

SBA's management assistance is especially important to EOL borrowers since it is usually the only assistance of this type they get. Only 8 of the 110 borrowers we talked with said they got management assistance from the Minority Business Development Agency other than help in preparing their

---

1/Some borrowers received management assistance from more than one source. See chapter 1 for a description of these management assistance programs.

2/Appendix V contains more details on borrowers' reactions to management assistance.

loan applications. <sup>1/</sup> Only five said they got free management assistance from other sources.

SBA's management assistance could better help EOL borrowers if, as discussed below, it (1) reached borrowers earlier and (2) there was more of it.

#### More timely management assistance needed

Few sampled EOL borrowers received SBA management assistance before their loans were approved, even though assistance at this point would seem especially important since all borrowers are then deciding how to spend loan proceeds and borrowers new to business are making many basic and irreversible choices.

An Assistant Director for Management Assistance at a district office we visited said that management assistance is most effective when it reaches a borrower early. A senior loan specialist at the Los Angeles District Office said that management assistance should be preventive, not corrective. An Assistant District Director for Finance and Investment at one district office said that management assistance is too late for delinquent borrowers.

That EOL borrowers have a particular need for early management assistance is indicated by the fact that many (1) recently started in business, (2) were inexperienced in their industry, and (3) encountered difficulties during the course of their loans. To illustrate this last point: (1) 62 percent of the loans we sampled became delinquent at some point and (2) problems were discovered in the businesses of two-thirds of sampled borrowers when visits were made by SBA personnel.

In spite of all this, only 10 of the 150 borrowers whose loan files were reviewed got SBA management assistance prior to loan approval. Management assistance usually reached these borrowers a considerable time after their loans were approved. SCORE assistance was given an average of about 6 months after loan approval, SBI after an average of about 10 months, and call contract assistance after an average of about 13 months. Of the 154 management assistance clients we sampled, 48 were new businesses when their loans were approved but

---

<sup>1/</sup>The Minority Business Development Agency is an agency of the Department of Commerce which provides management assistance and other services to minority businesses.

only 4 got assistance from SBA on where to locate their businesses.

The following are cases from our sample of borrowers who could have profited from early management assistance.

A Chicago borrower received a \$20,000 loan in February 1977 to open a liquor store. He also invested \$20,000 of his own funds in the business. He had no management experience when he applied for his loan. The loan officer declined to make a field visit before loan approval because no definite site had been selected. It was not until 7 months after the disbursement of the loan proceeds that the first field visit was attempted. At that time the SBA official was not able to contact the borrower, but noted that nearby competition was keen. The first loan payment had been due on July 17, 1977, but the borrower asked for and received a 3-month deferment. When the deferment expired, the loan became delinquent. When the borrower received another field visit in early December, the major problem identified was a bad business location. Still delinquent, the borrower added on a restaurant in order to build sales. When an SBA official visited again in the middle of the month, he observed that the biggest problem was that "the borrower picked a terrible location." At that time the borrower also advised him of his pending eviction for nonpayment of rent. The official acknowledged that the borrower needed considerable management assistance. The loan was placed in liquidation on December 29, 1977. After sale of collateral, the balance charged off in May 1978 was \$16,362. The borrower lost the \$20,000 he had invested in the business.

- - - - -

A \$50,000 EOL was approved in September 1977 for the owner of a small retail firm in Los Angeles. Because of several delinquencies, payments were deferred 11 months. During a field visit about 4 months after the loan was approved, an SBA official noted that the borrower was having accounting problems. The borrower felt that his business problems stemmed from seasonal sales and a lack of knowledge about advertising. SCORE and call contracting representatives spent a total of 6 hours at his business. According to the borrower, the

assistance had no impact on his sales, expenses, profits, or employees and was provided too late to be of use. His loan was placed in liquidation on February 25, 1980, with an outstanding balance of \$54,219. The borrower thought that management assistance should be provided before loans are disbursed and advice should be given on how to use the loan proceeds.

#### More extensive management assistance needed

As stated earlier in this chapter, the Small Business Act provides that management training required of EOL borrowers "must be of sufficient scope and duration to provide reasonable opportunity for the individuals served to develop entrepreneurial and managerial self-sufficiency." The assistance provided to management assistance clients we interviewed did not reach this level. At least half of these clients told us that SCORE counselors spent 3 or fewer hours at their businesses and that SBI and call contracting representatives were there 9 hours or less. This does not seem sufficient in view of the problems confronting most EOL borrowers.

- - - - -

In January 1980, an SBA consultant reported that the Call Contracting and SBI Programs were not appropriate for borrowers with the very small businesses and limited experience typical of many EOL borrowers. 1/

#### CONCLUSIONS

Because the EOL program has social as well as economic goals, and services businesses which cannot qualify for other Federal business lending, some departures from traditional lending practices seem warranted. The Small Business Act authorizes such special treatment for EOL borrowers. In response, SBA has employed a number of techniques to relieve borrowers' undercapitalization and mitigate their inexperience, including (1) short grace periods on initial loan repayments, (2) frequent deferments of payments during the course of the loan, (3) refinancing of troubled loans, and (4) limited management assistance usually provided some months after

---

1/"Major Impact Study of SBA Management Assistance Program," Rockville Consulting Group, Inc., January 1980.



loan approval. Another assistance technique--graduated repayment schedules under which loan payments increase as the business matures--has seldom, if ever, been used.

The remedy SBA applied most frequently to troubled borrowers at the offices we visited--deferring payments--has not worked well. Another attempted solution to the problems of delinquent borrowers, used most often at SBA's New York and Chicago district offices--refinancing--has also not worked well and is expensive. Three other techniques for assisting borrowers--grace periods on initial repayments, graduated repayment schedules, and early, intensive management assistance--have not been adequately tested because their use has been too limited.

Management assistance provided has had limited effect on improving program results. Most sampled borrowers did not request it. Those who did reported that it usually had no impact on their sales, expenses, profit, or number of employees. The assistance has been (1) mistimed, coming after borrowers had committed loan funds and new businesses had made many other crucial decisions and (2) too limited to meet the Small Business Act's requirement for scope and duration sufficient to develop "entrepreneurial and managerial self-sufficiency."

For many businesses, management assistance should come after a preliminary screening of the loan application but before the loan is disbursed. Intensive management analysis and counseling at this time could help loan officers in making final credit decisions, help borrowers who are starting businesses with their basic business strategies, and help all borrowers with decisions on how to spend loan proceeds. The funds received from an EOL usually are much greater than the borrower's own investment in the business. Therefore, decisions on how to spend the EOL are among the most important the borrower makes. No one should receive an EOL who refuses needed management assistance at this point.

#### RECOMMENDATIONS TO THE SBA ADMINISTRATOR

To improve the ability of the EOL Program to bring about improvements in the economic condition of low-income and

disadvantaged people, we recommend that the Administrator, SBA, test the effectiveness of three techniques for alleviating borrowers' undercapitalization and inexperience:

- Extended grace periods on initial interest repayments.
- Graduated loan repayment schedules providing for increasing payments during the life of the loan.
- More intensive and timely management assistance.

In addition, we recommend that (1) the SBA Administrator prevent the use of refinancing involving large additional outlays to borrowers who are unable to repay their first loan and (2) loans not be made to applicants who need but refuse management assistance in making initial business decisions, or deciding how to spend loan proceeds.

- - - - -

As indicated in chapter 1 of this report, the EOL Program is part of a larger SBA effort to assist minority-owned businesses. The major role in this effort is played by the 7(a) business loan program. As measured by loan repayment rates, minority business lending under the 7(a) program has been considerably more successful than in the EOL Program, as the 7(a) program's higher credit standards would lead one to expect. (See ch. 2.) Nevertheless, the default rate on minority business 7(a) loans is much higher than the 7(a) program average. The EOL and 7(a) Programs are administered by the same organizational units and are governed largely by the same procedures. Therefore, SBA should consider the application of our recommendations for the EOL Program to its minority business lending in the 7(a) program.

#### SBA COMMENTS AND OUR EVALUATION

SBA said that extending grace periods on initial loan payments and using graduated payment schedules might work, but believed they would not be much better than deferments and refinancings. SBA did not explain why it held this belief.

We acknowledge that the use of these techniques does not guarantee improved program results. That is why we recommended that they be tested. These techniques are authorized by the Small Business Act or by SBA's own procedures and, in our opinion, may improve borrowers' chances for success, especially those who are poorly capitalized and just starting businesses.

SBA also said that long-term management assistance might improve borrowers' success rates but that since borrowers were reluctant to accept the assistance, its "ultimate effectiveness may be nil." We recognize that many borrowers are uninterested in management assistance and have recommended that the approval of an applicant's loan be contingent on acceptance of needed management assistance before loan disbursement.

SBA's comments did not indicate what, if any, action SBA would take to improve the program. SBA said only that:

"Perhaps one of the most useful changes SBA could make is to inform loan applicants of the historical success/failure statistics for the program as a whole, in other words, the contents of your report. This information may assist the potential borrower to assess the desirability and risks attendant with starting a business or taking on greater financial obligations."

We agree.

RECOMMENDATION TO THE SENATE SELECT  
COMMITTEE ON SMALL BUSINESS AND THE  
HOUSE COMMITTEE ON SMALL BUSINESS

The committees should monitor SBA's implementation of our recommendations for management improvements made in this report and their impact on program results. If results do not improve, the committees should determine whether the objectives of the Economic Opportunity Loan Program could be more efficiently achieved by recommitting the program's funds to other Federal programs for socially and/or economically disadvantaged business people.

## CHAPTER 5

### OTHER OBSERVATIONS

Our review developed other information which needs to be brought to the attention of the Congress and SBA.

- Borrowers of direct EOLs pay a higher rate of interest than better qualified 7(a) direct loan borrowers.
- The eligibility of most sampled borrowers as "socially or economically disadvantaged" persons was not demonstrated by loan officers in their reports recommending loan approval.
- Most bankers we interviewed stressed that their participation in the EOL Program was contingent on their finding good credit risks. All but one said that their banks would not be induced to increase their participation by an increase in the SBA guarantee rate from 90 to 100 percent, as permitted by the Small Business Act.

### HIGHER INTEREST CHARGED ON DIRECT EOLs

Section 7(i)(5)(D) of the Small Business Act provides that the interest rate on direct EOLs be not less than

"\* \* \* a rate determined by the Secretary of the Treasury, taking into consideration the average market yield on outstanding Treasury obligations of comparable maturity \* \* \*."

Section 7(a)(4) of the Small Business Act provides a different formula for computing interest on 7(a) direct loans.

"\* \* \* the rate of interest for the Administration's share of any such loan shall be the average annual interest rate on all interest-bearing obligations of the United States then forming a part of the public debt \* \* \*."

The effect of the different statutory formulas is that a higher rate of interest is charged on direct EOLs than on direct 7(a) loans. Interest on direct EOLs and 7(a) loans is recomputed quarterly. At the end of fiscal year 1978, the interest rate for direct EOLs was 8-3/8 percent versus 7-3/8 percent for direct 7(a)s. At the end of fiscal year 1979, the EOL rate was 9-3/8 and the 7(a) rate 8-1/4. At the fiscal year 1979 rates, the monthly payment on a \$35,000, 1/8-year loan would be \$520 for the EOL borrower and \$500 for the 7(a) borrower. While the difference in the monthly payments is not great, over the life of the loans the EOL borrower, who may be in worse straits economically, would pay over \$1,900 more interest than the 7(a) borrower. There is nothing in the legislative history of the Small Business Act to indicate that the Congress directly considered this difference.

BORROWERS' ELIGIBILITY AS SOCIALLY  
OR ECONOMICALLY DISADVANTAGED  
PERSONS NOT ESTABLISHED

According to SBA procedures, to be eligible for an EOL, an applicant "must be a low-income individual or a person who, due to social or economic disadvantage, has been denied the opportunity to acquire adequate business financing through normal lending channels on reasonable terms." Loan officers are requested to comment on eligibility in their reports. In a revision of its procedures effective on October 4, 1979, SBA further instructed loan officers to "document all facts supporting a finding of social or economic disadvantage and the connection between such disadvantage and applicant's inability to obtain required financing on reasonable terms."

As mentioned in chapter 1 of this report, SBA considers that social or economic disadvantage can arise from (1) being a minority, (2) being a Vietnam-era veteran, (3) having a physical handicap, (4) living and doing business in an economically depressed area, or (5) other causes.

Social or economic disadvantage was a qualifying factor for 126 of the 150 loans we sampled at SBA's New

---

<sup>1</sup>/The average size of direct EOLs approved in the first half of fiscal year 1980 was \$35,103.

York, Chicago, and Los Angeles district offices, 1/ but loan officers did not usually explain why an applicant was economically or socially disadvantaged other than to state that he or she was a minority group member, a veteran, was located in an area of high unemployment or low income, or fell within one of the categories which SBA procedures say could result in disadvantage.

The following are quotes from loan officers' reports on sampled loans, exemplifying their explanations of social or economic disadvantage.

### Chicago

"borrower is eligible for EOL because he is a minority"--recommending approval for a Puerto Rican applicant.

\* \* \* \* \*

"applicant socially disadvantaged--applicants are black"--recommending approval for applicants reporting a family income of \$31,994 on a loan application dated May 1977.

\* \* \* \* \*

"Business belongs to a minority group and has a modest economic resource"--recommending approval for an Asian applicant reporting an annual salary of \$9,800 on a loan application dated March 3, 1976.

\* \* \* \* \*

"Vietnam Era--process under EOL criteria because of debt/worth and collateral"--recommending approval for white applicant reporting an annual family income of \$20,500 on a loan application dated July 3, 1975.

### Los Angeles

"Principal has experience in field and is part Mexican-American"

\* \* \* \* \*

---

1/Thirteen other borrowers qualified solely on the basis of low income. No explanation of eligibility was given for the remaining 11 loans.

"Applicant is a Vietnam era veteran and appears to qualify on the basis of family income."--recommending approval for a white applicant reporting family income of \$16,032 on a loan application dated November 29, 1976.

\* \* \* \* \*

"Business is owned by a general partnership formed between father and son. The son is a Vietnam Veteran, has a nominal [net worth] of \$1,150 and a reported gross income of \$7,220 for a family of (3) in 1975. Owners of business are non-minority."--Figures quoted in the loan officer's report are for the son. The father reported a family income of \$15,922 on a loan application dated July 1, 1976.

\* \* \* \* \*

"Applicant is a member of black community with minimal net worth. Application turned down by two banks. As such loan is processed under EOL criteria."--recommending approval for applicant reporting a family income of \$16,275 for 1974.

\* \* \* \* \*

"Processed under EOL criteria. 1/2 of the partnership is a Vietnam era veteran; the other 1/2 is a woman. Both are low income."--recommending approval of a loan to two white lawyers to finance their law firm. The male partner had a income of \$13,287 in 1975 and \$15,768 in 1974. The woman partner's income was \$12,900 in 1975 and \$6,851 in 1974.

New York

"No question of eligibility \*\*\* Disadvantaged economically due to geographic area and business location."--recommending approval for two Hispanic partners reporting family incomes averaging \$18,800 on a loan application dated January 22, 1976. Their business was located in the New York City suburbs.

\* \* \* \* \*

RECOMMENDATION TO  
THE CONGRESS

The Congress should determine whether the higher interest paid by borrowers of direct EOLs is justified by the greater risk associated with EOL lending or whether in the interests of fairness for disadvantaged businesses, the rates should be the same.

If the Congress finds that the rates should conform, and that the 7(a) rate is appropriate for both programs, the Small Business Act should be amended by changing section 7(i)(5)(D) of the act to incorporate the formula used in section 7(a)(4).



As mentioned above, on October 4, 1979, SBA strengthened its instructions to loan officers on how to determine an applicant's eligibility. Close monitoring by SBA headquarters personnel will be needed to ensure that improvements actually do occur.

#### BANK PARTICIPATION IN THE EOL PROGRAM

Bank participation in the EOL Program has fallen off in recent years. As the table on page 4 indicates, the number of guaranteed EOLs declined by 262 from fiscal years 1976 to 1979. Guaranteed lending through May of fiscal year 1980 was below the 1979 level.

We talked with officials of 11 banks in New York, Chicago, and Los Angeles which had participated in the EOL Program. Most stressed to us that their lending depended mainly upon the credit worthiness and business prospects of the loan applicant. Some said that the paperwork required on SBA loans tended to depress their participation. All but one said that increasing the SBA guarantee rate on EOLs from 90 to 100 percent (the Small Business Act permits a full guarantee) would stimulate little if any additional guaranteed lending.

#### CONCLUSIONS

Because the Small Business Act provides different formulas for computing interest on direct loans under the 7(a) and EOL Programs, borrowers of direct EOLs pay more interest. The legislative history of the Small Business Act does not indicate that the Congress considered the consequences of the different formulas. While the higher EOL rate might be justified by the program's higher risk, the issue of whether the difference is fair to disadvantaged EOL borrowers should also be considered by the Congress.

Borrowers received loans at the cities we visited without adequate consideration of their eligibility as disadvantaged persons.

#### RECOMMENDATION TO THE SBA ADMINISTRATOR

To ensure that EOLs are made only to persons eligible under SBA regulations, we recommend that the Administrator, SBA, monitor closely the compliance of loan officers with recently established procedures calling for a fuller consideration of whether loan applicants are disadvantaged.

liquidation) but gave only a partial history of the other category of borrowers who had left the program (borrowers who had paid their loans in full). In order to determine what success these borrowers experienced in business, we selected a sample of loans which had been paid in full at the New York, Chicago, Miami, and Los Angeles district offices in fiscal years 1969 through 1978. <sup>1/</sup> These offices accounted for 17.7 percent of all EOLs paid in full during the period. We used this sample to estimate how many EOL borrowers had remained in business and how many businesses financed by the loans had lasted.

As a first step in this process, we wanted to identify those paid-in-full loans which represented borrowers leaving the program with operating businesses.

At the Chicago office we reviewed records for each of the 337 loans shown as paid in full during the period. At the other three district offices we visited, the larger number of paid-in-full loans made it impractical to review all loan records; therefore, we took a random sample. We found that not all loans recorded as paid in full represented borrowers who left the program with going businesses. As shown in the following table, some loans were paid in full by refinancing, by liquidating the borrower's business, or were canceled loans misclassified as paid in full.

---

<sup>1/</sup>Loan files for the relatively few EOLs paid in full before fiscal year 1969 have been destroyed.

## CHAPTER 6

### SCOPE AND METHOD OF THE REVIEW

We did all phases of our review at SBA's district offices in New York, Chicago, and Los Angeles. We added the SBA Miami district office to the other three for our analysis of paid-in-full loans in order to get the maximum feasible coverage of this important review segment. These offices were selected because of their size and geographic dispersion. Representatives of SBA's Offices of Small Business Loans and Portfolio Management said that they adequately represented activity in the EOL Program nationwide. We reviewed records relating to 516 loans and interviewed 233 borrowers. We used a translator to interview Spanish-speaking borrowers in the Miami area.

We discussed the program with SBA headquarters officials, including officials of the SBA Inspector General's Office, officials of the Department of Commerce's Minority Business Development Agency, and representatives of banks who were or had been active in minority business lending. We also reviewed past studies of the program.

We copied SBA's computer-maintained master loan records of all EOLs disbursed from the start of the program through fiscal year 1978, and analyzed the records on our own computer. Chapter 2 and appendix II contain the results of the analysis. We tested the reliability of the data contained in the ADP records by comparing it with information contained in the loan files we sampled. Although some discrepancies were found, they were not so numerous as to destroy the usefulness of the records for purposes of this report.

Much of the data presented in this report was derived from three scientific, randomly selected EOL samples from the district offices mentioned above, as discussed in the following sections.

#### SAMPLE OF EOL BORROWERS WHO PAID THEIR LOANS IN FULL

The principal objective of our review was to determine the program's effectiveness as measured by the number of borrowers who had established lasting businesses. Our analysis of data on loan repayment and default provided information about the number of borrowers who failed in business before leaving the program (those whose loans were charged off or in

3. asked neighboring businesses at the borrower's former business address whether they knew of the borrower's whereabouts and current occupation;
4. finally, if we were still unable to find the borrower, we contacted his bank of account as shown in SBA records for a current address and occupation.

The results of our work are presented in a table below. The table contains a special category of business which has to be treated separately from other businesses for purposes of classifying its continued existence--New York City taxicabs. The principal asset of these cab businesses is a "medallion," a kind of license to operate a cab. These medallions are transferable and never expire; even if a particular cab owner leaves the business and his vehicle is no longer used as a cab, the business represented by the medallion will continue to exist.

	<u>New York</u>		<u>Los Angeles</u>		<u>Miami</u>		<u>Chicago</u>	
	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>	<u>Number</u>	<u>Percent</u>
Borrower still in business (note a):								
Yes (note b)	23	43	34	56	26	48	21	34
No	<u>31</u>	<u>57</u>	<u>27</u>	<u>44</u>	<u>28</u>	<u>52</u>	<u>41</u>	<u>66</u>
Total	<u>54</u>	<u>100</u>	<u>61</u>	<u>100</u>	<u>54</u>	<u>100</u>	<u>62</u>	<u>100</u>
Business still in existence (note a):								
Yes	22	41	50	82	32	59	25	40
No	17	31	10	16	22	41	37	60
Yes - taxi	15	28	-	-	-	-	-	-
Cannot determine	-	-	<u>1</u>	<u>2</u>	-	-	-	-
Total	<u>54</u>	<u>100</u>	<u>61</u>	<u>100</u>	<u>54</u>	<u>100</u>	<u>62</u>	<u>100</u>

a/Figures are unweighted sample results.

b/Includes 11 borrowers who left their original businesses and started other businesses.

Analysis of Loans Paid in Full from  
Fiscal Years 1969 through 1978 at SBA's New York,  
Chicago, Los Angeles, and Miami District Offices

	<u>New York</u>	<u>Los Angeles</u>	<u>Miami</u>	<u>Chicago</u>	<u>Total</u>
All loans recorded as paid in full	<u>1,101</u>	<u>505</u>	<u>836</u>	<u>337</u>	<u>2,779</u>
Total loans reviewed	74	90	55	337	
Less:					
Refinanced loans	15	27	1	98	
Paid in full by liquidation	2	2	-	10	
Misclassified	<u>3</u>	<u>-</u>	<u>-</u>	<u>8</u>	
Loans representing potentially successful borrowers	<u>54</u>	<u>61</u>	<u>54</u>	<u>221</u>	
Loans selected for further analysis	54	61	54	62	231

As the table indicates, we selected 231 loans paid off by borrowers who were leaving the program with ongoing businesses to find out what had happened to these borrowers in the ensuing years.

We made two basic determinations. First, whether the borrower was still in business; second, whether the business owned by the borrower when he got the loan was still in existence. In order to make these determinations, we

1. consulted SBA records, local telephone directories, and the phone company's directory assistance to determine the borrower's current business and personal address;
2. if these sources were not fruitful, we visited the last location of the borrower's business shown in SBA records; and

SAMPLE OF BORROWERS WHO RECEIVED  
MANAGEMENT ASSISTANCE

Our third major sample was of EOL borrowers whose loans were approved at SBA's New York, Chicago, and Los Angeles district offices during fiscal years 1976 through 1978 and who had received management assistance from the SCORE, SBI, or Call Contracting Programs. Some of these loans were also included in the loan approval sample discussed above. We interviewed 110 of these borrowers--40 each in the New York and Chicago areas--and 30 in the Los Angeles area, principally to obtain their views on the management assistance they received. The results of these interviews are presented in chapter 4 and appendix V.

The borrowers shown on the chart as out of business consist of 43 borrowers whose current status or occupation we could determine and 84 borrowers we could not locate. We believe it is reasonable to conclude that the borrowers we were unable to find were out of business for the following reasons: (1) the businesses operated by most of these borrowers no longer existed, indicating that the borrowers had not recovered their investment through sale of the EOL-funded business, 1/ (2) few of the borrowers we were able to locate who had terminated their original business had reestablished another business, (3) banks and neighboring business-people had no knowledge of any new business venture begun by these borrowers, and (4) the local phone company had no listing for the borrowers.

SAMPLE OF LOANS APPROVED DURING  
FISCAL YEARS 1976 THROUGH 1978

We also took a random sample of 150 EOLs approved during fiscal years 1976 through 1978 at SBA's New York, Chicago, and Los Angeles district offices. The three district offices accounted for 11.7 percent of all EOL lending in the period.

We excluded from this sample loans made by the Los Angeles district office to cab owners. These loans were made under a special effort to assist drivers formerly employed by a bankrupt taxicab company to buy their own cabs. During fiscal years 1976 through 1978, SBA guaranteed 203 cab loans under the EOL Program. Almost all were for the same amount--\$8,620. The taxi loans represented 48 percent of all EOLs (75 percent of all guaranteed EOLs) approved at Los Angeles from fiscal years 1976 through 1978. We excluded these cab loans from our sample because they were processed for approval in batches under special procedures and because the cab owner/operators did not have the same management assistance needs as other borrowers.

We used this sample to develop a profile of EOL borrowers in terms of age, experience, education, and other factors and to obtain information on SBA's loanmaking practices, including its credit analysis of loan applications and its loan servicing and management assistance. The results of this sample are presented mainly in chapters 3 and 4.

---

1/Of the 78 non-cab businesses owned by borrowers that we were unable to locate, 57 no longer existed.

report discusses the continued needed for these improvements in SBA's management assistance programs. We also recommended the establishment of goals for creating successful businesses and measurement of progress toward reaching these goals. Chapter 3 of this report indicates that SBA has not adopted these recommendations.

#### CONGRESSIONAL COMMITTEE REPORT

3. Final Report, House Permanent Select Committee on Small Business. House Report No. 93-1651 (Dec. 30, 1974).

The committee was concerned with losses in the EOL Program as the following excerpts from the report indicate.

"For several years, this committee has expressed concern about the number and dollar volume of slow, trouble and liquidated economic opportunity loans resulting in substantial losses. Testimony at the oversight hearings in September 1973 and various SBA reports indicate that about one out of every three or four loans fall in one of the above categories.

"This committee does not consider this percentage of trouble loans acceptable. The Small Business Act provides that no loans should be made without reasonable assurance of repayment. This loss ratio would indicate that many loans are made without adequate investigation and, also, that stronger collection policies and procedures are needed as well as more substantial management and technical assistance to these borrowers."

#### SBA INTERNAL AUDIT REPORT

4. "Report of Audit on a Review of the Economic Opportunity Loan Program," SBA Internal Audit Division (June 18, 1976).

--EOL applicants were being judged eligible for loans solely because of classification in a minority group without consideration of the individual's personal history or circumstances,

--SBA had not developed a satisfactory definition of "low income" as a basis for measuring eligibility, and

--SBA had not adequately evaluated factors affecting applicants' repayment ability.



OTHER STUDIES OF THE EOL PROGRAM  
AND FEDERAL MINORITY BUSINESS LENDING

The following are summaries of, or pertinent excerpts from, major studies of the EOL Program or the Federal Government's overall minority business development effort. 1/

OUR REPORTS

1. "Survey of Economic Opportunity Loan Program Shows Need for Improved Administration and Increased Effectiveness" (B-130515, Apr. 23, 1969).

--Program results were not being effectively measured.

--SBA was not always carefully evaluating loan applicants' repayment abilities.

We recommended that SBA collect data to determine the growth and status of borrowers after loan approval as a way of measuring program results. Chapter 3 of this report indicates that SBA has not done this on a regular basis. We also recommended that loan specialists improve their analysis of applicants' repayment ability. Chapter 3 of this report discusses continuing deficiencies in this area.

2. "Limited Success of Federally Financed Minority Businesses in Three Cities" (B-149685, Nov. 8, 1973).

--More than half the minority-owned businesses which got SBA loans (including EOLs) in fiscal years 1969 and 1970 at the three cities where we did our review were classified as failures or probable failures.

--SBA's management assistance had little impact on borrowers.

--SBA had measured the success of its program by loans made rather than by successful businesses established.

We recommended earlier and more intensive management assistance for minority-owned businesses. Chapter 4 of this

---

1/See chapter 1 for additional discussion of these reviews.

- SBA improve its management system to assure that EOL financial assistance is provided only in conjunction with market or management assistance in those cases where such additional assistance is considered to be necessary, and
  - the administration request the Congress to increase the ceiling on the amount of an SBA EOL loan from \$50,000 to \$100,000. (The ceiling was raised to \$100,000 by Public Law 94-305.)
6. "Federal Programs for Financing Minority Business," Department of the Treasury (Dec. 1978).

The report concluded with regard to the EOL Program that:

"It is clear that any credit program with loan loss rates of this size is considerably more than a credit program and is serving social goals other than simply offsetting the effects of historical discrimination. Yet there has been, to our knowledge, no articulation of the other goals, and no assessment of the degree to which the program has been a success in permitting entrepreneurs to enter businesses that have a reasonable chance of surviving. While each borrower may be required to accept management assistance, there appears to have been no continual evaluation of its adequacy or its potential for filling in gaps in business experience. In the administration of the program, more emphasis appears to have been placed on the number of businesses assisted rather than on business viability.

"In our view, the goal of the EOL program should not be only to expand the number of firms at the lower end of the business spectrum. It should be to help minority firms grow."

The report recommended

- making fewer but larger loans to minority business and placing relatively less emphasis on businesses for the lowest income levels;
- that since many EOL borrowers were not "good candidates for the entrepreneurial life," SBA examine loan applicants more critically, possibly with the

In the "Fact Sheets" prepared on their review, the internal auditors estimated that almost 53 percent of the EOLs disbursed from fiscal years 1965 through 1975 would be charged off within 10 years of their disbursement. Losses on these loans were estimated at \$208 million, almost 38 percent of the total amount disbursed during the period.

#### OTHER FEDERAL GOVERNMENT STUDIES

5. "Interagency Report on the Federal Minority Business Development Programs," Office of Management and Budget in cooperation with the Department of Commerce and the Small Business Administration (Mar. 1976).

The report concluded the following with respect to Federal efforts to finance minority businesses.

"Loans have in the past frequently been provided to firms which have very little chance of success. This is reflected in a high loss rate on the loans. But more importantly, it can lead to a worsened economic status for the minorities involved, as their investments are lost in businesses which were undertaken with Federal assistance and encouragement.

"Financial assistance has frequently been provided to minority firms without assuring that other types of needed assistance (such as procurement and management assistance) will be made available. There presently are inadequate management systems to assure that the complementary pieces of Federal assistance required to give a firm a reasonable chance of success will all be available to a firm.

"The present ceiling of \$50,000 on SBA's Economic Opportunity Loan program does not allow adequate flexibility to provide the amount of financing needed to give firms a reasonable chance of success. Studies indicate that inadequate financing is a primary cause of failure for small firms."

With respect to the EOL Program, the report recommended that

--SBA establish improved criteria for acceptance of applications for EOLs to help assure that loans are provided only to those firms with a reasonable chance of success,

of 200 years of socio-economic struggle on the part of this country's minorities. Most minority business persons are first generation managers/entrepreneurs. Progress will be made, but in light of the limited capacity of [minority businesses] and the slowdown of the entire U.S. economy, it will be made at a slow pace.

- "3. Interest of Private Sector in [Minority Business Development]. The Federal Government realizes that it will only be able to have a major impact on [minority business development] with the assistance of the private sector, but it has been rather naive in terms of the motivation necessary to get the private sector involved. The private sector is bottom-line oriented, and until the Federal Government shows the private sector how [minority business development] will put money into its coffers, it will not come to the rescue."

The report recommended that the primary mission of the Government in the area of minority business should be "to develop a core group of minority businesses and business leaders that can have a significant impact on society." This group would

- "1. Manage and develop businesses of size;
2. Employ large numbers of minority workers in both urban and rural areas;
3. Assume policy-making roles in Government and on the boards of Fortune 500 firms; and
4. Provide role models for subsequent generations of minority youth."

One of the major objectives of the Federal effort would be to help minority businesses get access to larger markets. In this regard the report stated that:

"The key to growth in profits, asset base and return on investment is sales. As long as [minority businesses] continue to market their products to limited markets, they will experience limited growth and success. [Minority businesses] must not be limited to the markets where they are located but must penetrate the majority, international and Government markets where there is real purchasing power."

aid of "objective criteria" for judging businesses' viability; and

--that SBA consider increasing the use of graduated repayment schedules to ease the debt service obligations of recipients in their initial years of operation.

7. "A New Strategy for Minority Business Enterprise Development," a study prepared for the Assistant Secretary for Policy, U.S. Department of Commerce, by James H. Lowry and Associates (Apr. 1979).

According to the report, Federal programs for minority businesses are incapable of "getting the job done" because they do not focus on the "three critical problems" of these businesses, which are

--lack of capable managers,

--inadequate capital for business formation and expansion, and

--lack of access to major growth markets.

Past Federal efforts have "reinforced the traditional minority business enterprise's focus on marginal retail/service businesses with limited prospects for growth." The Government had "disregarded the realities of the free enterprise system \* \* \* particularly in respect to:

- "1. Abilities Needed to Start and Manage a Successful Business. The relevant Federal agencies have not established any criteria in terms of management, education, experience, or potential for the individuals they have attempted to assist. Therefore, they provide management and technical assistance to individuals who cannot appreciate it and therefore will always require it and waste it. Also, loans are made to individuals who are destined to lose the funds because they do not even know how to keep track of them.
- "2. Speed at Which Change Occurs. The present status of [minority business development] is the result

in full. As indicated in chapter 1, most EOLs outstanding on September 30, 1978, had maturities of about 8 years. On the other hand, according to officials of SBA's Office of Small Business Loans and Office of Portfolio Management, most loans that go into liquidation do so within a few years of disbursement. Therefore, a loan that will eventually be paid in full usually remains in the active portfolio longer than a loan that will be charged off. Because paid-in-full and defaulted loans are typically in the active portfolio for different lengths of time, the ultimate default rate on all disbursed loans will probably be between (1) the ratio of defaulted loans to disbursed loans and (2) the ratio of defaulted loans to program completions.

The fewer the loans left in the active portfolio, the closer the "defaulted loans to program completion" ratio would represent the ultimate failure rate in the program. Therefore, it is useful to consider another ratio: the active portfolio as a percent of all disbursed loans.

We did a computerized analysis of the repayment rates of various categories of EOLs, as shown in the following tables. Direct loans are presented separately because they are greater credit risks and are the loan type with the greatest Federal involvement; minority loans are shown separately because the program is used principally to develop minority business. For ease of presentation, the numbers of loans on which the ratios are based are shown after the tables.

EOL DEFAULT RATES AND ACTIVE PORTFOLIOCLASSIFIED BY BORROWER AND BUSINESS TYPE

There is some correlation between what happened to a borrower's loan and his business. Therefore, data on the repayment and default 1/ of EOLs provide some indication of borrowers' business history.

- Defaulted loans represent failed businesses.
- Paid-in-full loans represent borrowers who may have established lasting businesses. 2/
- Loans still in the active portfolio represent a mix of borrowers, some of whom will pay their loans in full and establish lasting businesses and others who will default on their loans.

In analyzing what the loan default figures say about the success and failure of borrowers, some ratios are useful. None of them are sufficient singly to fully describe the program's results, but viewed together they provide some understanding of its productivity.

First is the ratio of defaulted loans to all disbursed loans. This figure indicates the percentage of borrowers who have already failed. Another helpful ratio is defaulted loans to all program completions. "Program completions" in this sense would be all borrowers who are no longer in the active portfolio--that is, those who have left the portfolio because their loans were paid in full or went into default. This second ratio tends to overstate the proportion of borrowers who will eventually leave the program as failures because loans usually go into default faster than they are paid

---

1/As used in this appendix, defaulted loans are loans which have been charged off or placed in liquidation.

2/As indicated in chapter 2 of this report, the number of paid-in-full loans overstates the number of borrowers who established lasting businesses.

Table II  
Significant Ratios Classified by the Borrowers'  
Annual Family Income (in Thousands of Dollars)

<u>Type of Loan</u>	<u>less</u> <u>than 5</u>	<u>5-9</u>	<u>9-12</u>	<u>12-20</u>	<u>over</u> <u>20</u>	<u>Not</u> <u>coded</u> <u>(note a)</u>
Defaulted loans as a percent of loans disbursed:						
Direct	44	39	37	33	29	49
Minority	42	37	35	31	27	48
All	41	36	33	29	25	46
Defaulted loans as a percent of program comple- tions:						
Direct	65	63	65	65	62	56
Minority	62	59	59	56	56	56
All	60	57	57	54	54	52
Active portfolio as a percent of loans disbursed:						
Direct	32	38	43	49	54	12
Minority	32	37	40	44	52	14
All	32	37	42	47	53	13

a/Family income was not recorded in SBA records for 18,971 loans (34.4 percent of all disbursed).



EOL LOANS: DEFAULT RATES AND ACTIVE PORTFOLIO  
AS A PERCENT OF LOANS DISBURSED

Table I  
Significant Ratios Classified by Whether the Borrowers'  
Business Was New or Existing

<u>Type of loan</u>	<u>New business (note a)</u>	<u>Existing business (note a)</u>	<u>Not coded (note b)</u>
Defaulted loans as a percent of loans disbursed:			
Direct	47	37	48
Minority	44	35	46
All	42	34	46
Defaulted loans as a percent of program comple- tions:			
Direct	64	61	53
Minority	61	57	51
All	59	55	50
Active portfolio as a percent of loans disbursed:			
Direct	28	40	8
Minority	28	38	9
All	29	39	8

a/SBA classifies a business as "new" if it has been in existence less than 180 days at loan approval. All other businesses are considered "existing."

b/SBA records did not indicate whether 8,975 loans (16.3 percent of all disbursed loans) were made to new or existing businesses. Most of these loans (and loans shown as "not coded" on the following charts) were made early in the program's history as is indicated by the small portion still outstanding in the portfolio.

Table IV  
Significant Ratios Classified by Borrower Type

<u>Type of loan</u>	<u>Minority</u>	<u>Nonminority</u>	<u>Not coded (note a)</u>
Defaulted loans as a percent of loans disbursed:			
Direct	42	40	51
Guaranteed	34	23	30
All	39	33	49
Defaulted loans as a percent of program comple- tions:			
Direct	63	56	55
Guaranteed	48	37	24
All	58	49	53
Active portfolio as a percent of loans disbursed:			
Direct	33	29	7
Guaranteed	29	38	4
All	32	32	8

a/The records for 4,530 loans (8.2 percent of all loans disbursed) do not indicate whether the borrower was a minority group member or not.

Some patterns are disclosed by the data. Borrowers of direct loans have been much less successful in every lending category than guaranteed borrowers. (See tables I through IV.) Minority-owned businesses have not been as successful as non-minority businesses except that minority businesses with guaranteed loans have fared better than nonminority direct loan borrowers. (See tables I through IV.)

Businesses that were already existing at the time of loan approval tended to have better repayment rates than new businesses (see table I); and borrowers with higher family incomes were more successful than poorer borrowers (see table II).

Results are now "in" for two-thirds of the loans disbursed in several loan categories: new businesses (see table I), loans to borrowers with family incomes of less than \$5,000 (see table II), loans of \$15,000 or less (see table III), and loans to minority and nonminority borrowers

Table III  
Significant Ratios Classified by  
Loan Approval Amount (in Thousands of Dollars) (Note a)

<u>Type of loan</u>	<u>Less than 5</u>	<u>5-10</u>	<u>10-15</u>	<u>15-20</u>	<u>20-30</u>	<u>Over 30</u>
Defaulted loans as a percent of loans disbursed:						
Direct	51	44	43	40	40	29
Minority	50	40	39	38	39	27
All	49	40	40	37	37	25
Defaulted loans as a percent of program completions:						
Direct	56	56	60	65	65	82
Minority	56	52	57	60	62	71
All	54	51	55	57	59	67
Active portfolio as a percent of loans disbursed:						
Direct	10	21	28	38	38	65
Minority	11	24	31	36	37	62
All	9	21	27	36	37	63

a/The approved loan amount was not recorded in SBA records for 415 loans (0.8 percent of all disbursed loans).

Table VI  
Loans by Annual Family Income of Borrowers  
(in Thousands of Dollars)

<u>Type of loan</u>	<u>Less than 5</u>	<u>5-9</u>	<u>9-12</u>	<u>12-20</u>	<u>Over 20</u>	<u>Not coded</u>
<b>Direct:</b>						
Disbursed	6,184	8,500	4,539	3,485	838	14,063
Defaulted	2,705	3,315	1,695	1,157	240	6,837
Paid in full	1,471	1,929	910	632	147	5,474
In portfolio	2,008	3,256	1,934	1,696	451	1,752
<b>Minority:</b>						
Disbursed	6,033	9,565	5,634	4,601	1,175	9,793
Defaulted	2,543	3,522	1,988	1,438	318	4,675
Paid in full	1,560	2,496	1,370	1,124	248	3,719
In portfolio	1,930	3,547	2,276	2,039	609	1,399
<b>All:</b>						
Disbursed	8,347	12,700	7,455	6,072	1,551	18,971
Defaulted	3,433	4,553	2,465	1,741	394	8,663
Paid in full	2,273	3,411	1,845	1,490	340	7,870
In portfolio	2,641	4,736	3,145	2,841	817	2,438

Table VII  
Loans by Approval Amount (in Thousands of Dollars)

<u>Type of loan</u>	<u>Less than 5</u>	<u>5-10</u>	<u>10-15</u>	<u>15-20</u>	<u>20-30</u>	<u>Over 30</u>
<b>Direct:</b>						
Disbursed	6,991	9,231	6,872	3,856	6,855	3,472
Defaulted	3,545	4,061	2,985	1,555	2,747	993
Paid in full	2,762	3,190	1,962	820	1,486	218
In portfolio	684	1,980	1,925	1,481	2,622	2,261
<b>Minority:</b>						
Disbursed	5,502	8,197	6,238	4,476	7,984	4,403
Defaulted	2,753	3,269	2,431	1,716	3,115	1,200
Paid in full	2,159	2,979	1,848	1,155	1,885	490
In portfolio	590	1,949	1,959	1,605	2,984	2,713
<b>All:</b>						
Disbursed	8,503	12,907	9,950	6,279	10,753	6,289
Defaulted	4,136	5,192	3,982	2,295	3,991	1,577
Paid in full	3,566	4,985	3,270	1,746	2,736	771
In portfolio	801	2,730	2,698	2,238	4,026	3,941

(see table IV). More than 55 percent of the borrowers in almost all of these categories who have left the program defaulted on their loans. The program has been least beneficial for direct loan borrowers with new businesses or low incomes; it has been most beneficial for nonminorities.

The following tables show the numbers of loans on which the ratios shown above were based.

Table V  
Loans by Type of Business

<u>Type of loan</u>	<u>New business</u>	<u>Existing business</u>	<u>Not coded</u>
<b>Direct:</b>			
Disbursed	13,279	16,999	7,331
Defaulted	6,186	6,225	3,538
Paid in full	3,414	3,948	3,201
In portfolio	3,679	6,826	592
<b>Minority:</b>			
Disbursed	14,322	19,795	2,684
Defaulted	6,314	6,923	1,247
Paid in full	4,045	5,284	1,188
In portfolio	3,963	7,588	249
<b>All:</b>			
Disbursed	19,872	26,249	8,975
Defaulted	8,323	8,830	4,096
Paid in full	5,865	7,219	4,145
In portfolio	5,684	10,200	734

PROJECTION OF SAMPLE RESULTSFOR PAID-IN-FULL LOANS

<u>Sampling attribute</u>	<u>Estimated percent of loans (note a)</u>	<u>Sampling error 95% confidence (note a)</u>	<u>Estimated number of loans (note b)</u>	<u>Sampling error 95% confidence</u>
		(+ -)		(+ -)
Loans which left the portfolio (note c)	100.0	-	6,882	-
Loans charged off or in liquidation (note c)	59.6	-	4,103	-
Loans recorded as paid in full (note c)	40.4	-	2,779	-
Loans paid in full by refinancing	6.7	1.6	460	110
Loans paid in full by liquidation or misclassified as paid in full	1.3	0.1	90	10
Borrowers leaving program with going businesses	32.5	1.7	2,230	120
Borrowers who repaid their loans and are still in business	14.6	2.5	1,010	170
Borrowers who repaid their loans but are no longer in business	17.9	2.5	1,230	170
Businesses whose loans were repaid and were still in existence (excluding New York City taxis)	17.3	2.4	1,190	170
New York City taxis whose loans were repaid	3.6	1.6	250	110
Businesses whose loans were repaid and were still in existence (including New York City taxis)	20.9	4.0	1,440	270
Businesses whose loans were repaid but which are no longer in existence	11.5	2.3	790	160

a/Percentages computed independently from unrounded data.

b/Estimates rounded.

c/Data obtained from SBA records, not estimated from the sample.

Table VIII  
Loans by Borrower Type

<u>Type of loan</u>	<u>Minority</u>	<u>Nonminority</u>	<u>Not coded</u>
Direct:			
disbursed	25,223	8,186	4,200
defaulted	10,541	3,260	2,148
paid in full	6,273	2,547	1,743
in portfolio	8,409	2,379	309
Guaranteed:			
disbursed	11,312	5,256	164
defaulted	3,856	1,215	50
paid in full	4,140	2,031	107
in portfolio	3,316	2,010	7
All:			
disbursed	36,801	13,765	4,530
defaulted	14,484	4,539	2,226
paid in full	10,517	4,769	1,943
in portfolio	11,800	4,457	361

--Percent of sales to total assets. "This ratio is a general measure of a firm's ability to generate sales in relation to total assets. It should be used only to compare firms within specific industry groups and in conjunction with other operating ratios to determine the effective employment of assets."

RMA presents these ratios for various size firms within industries. The smallest size category presented is firms with less than \$250,000 in assets. We calculated the ratios discussed above for sampled borrowers whose loans were charged off or in liquidation based on projections of profit and sales submitted by the borrowers with their loan applications.

The following table compares the ratios for sampled borrowers with the upper quartile ratios presented in the RMA "1978 Annual Statement Studies" for firms in the same industries with assets below \$250,000.

Projections of Sampled Borrowers Whose  
Loans Were Charged Off or in Liquidation  
Compared with Industry Averages per  
Robert Morris Associates

<u>District office</u>	<u>Percent of profits before taxes to tangible net worth</u>		<u>Ratio of sales to total assets</u>	
	<u>Borrowers' projections</u>	<u>RMA upper quartile</u>	<u>Borrowers' projections</u>	<u>RMA upper quartile</u>
Los Angeles				
1	43.4	45.0	1.47	3.2
2	488.5	57.9	2.35	4.6
3	116.2	42.5	2.41	3.5
4	39.4	73.9	1.45	4.8
5	339.6	85.1	5.13	5.4
6	55.6	27.3	2.57	3.8
7	62.9	73.9	3.74	4.8
8	251.6	57.9	1.44	4.6
9	31.2	57.9	1.40	4.6
10	23.4	52.4	1.65	2.0
11	176.1	34.5	3.10	2.4



COMPARISON OF BORROWERS' PROJECTIONS WITH  
INDUSTRY AVERAGES COMPUTED BY  
ROBERT MORRIS ASSOCIATES

Robert Morris Associates (RMA), a national association of bank loan and credit officers, publishes annually an analysis of financial statements of businesses in various industries. SBA procedures state that the Robert Morris figures (and other statistical compilations) "are useful to the Loan Officer and the applicant to compare the operation and financial condition of a business against industry averages." RMA recommends that its "Statement Studies" data be regarded as general guidelines and not as absolute industry norms.

The RMA "Annual Statement Studies" present data by industry and by size of firm within the industry. Where information is available, ratios of certain income statement and balance sheet items are calculated. Each ratio has three values: the upper quartile, median, and lower quartile. According to RMA,

"\* \* \* the figure which falls in the middle between the strongest and the weakest ratios is the median. The figure that falls halfway between the median and the strongest ratio is the upper quartile. The figure that falls halfway between the median and the weakest ratio is the lower quartile." (Underscoring supplied.)

Among the ratios presented in the RMA studies are (1) the percent of profits before taxes to tangible net worth and (2) the percent of sales to total assets. RMA explains these ratios as follows:

--Percent of profits before taxes to tangible net worth. "This ratio expresses the rate of return on tangible capital employed. While it can serve as an indicator of management performance, the analyst is cautioned to use it in conjunction with other ratios. A high return, normally associated with effective management, could indicate an undercapitalized firm. Whereas, a low return, usually an indicator of inefficient management performance, could reflect a highly capitalized, conservatively operated business."

SELECTED RESPONSES BY EOL BORROWERS TO  
GAO QUESTIONNAIRE ON SBA MANAGEMENT ASSISTANCE

1. Considering the type of assistance you received from the program, how adequate or inadequate was the level to which the SBA counselor(s) analyzed your business? Would you say it was:

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. More than adequate	3	17	24
2. Generally adequate	8	14	24
3. Marginally adequate	1	11	7
4. Generally inadequate	1	3	6
5. Very inadequate	5	4	5

2. Overall, how familiar, in terms of background and experience, if at all, was the counselor with the needs and problems of your type of business? Would you say the counselor had a:

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. Very high degree of familiarity	2	1	15
2. High degree of familiarity	3	6	12
3. Moderate degree of familiarity	4	12	17
4. Some degree of familiarity	2	6	6
5. Little or no degree of familiarity	7	25	16

3. In general, how clear were the recommendations? Would you say they were:

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. Very clear	6	26	42
2. Generally clear	5	12	14
3. Borderline	2	3	4
4. Generally unclear	1	0	3
5. Very unclear	3	3	1
6. No recommendation made	1	7	1

<u>District office</u>	<u>Percent of profits before taxes to tangible net worth</u>		<u>Ratio of sales to total assets</u>	
	<u>Borrowers' projections</u>	<u>RMA upper quartile</u>	<u>Borrowers' projections</u>	<u>RMA upper quartile</u>
Chicago				
12	200.0	68.8	11.6	12.0
13	20.5	63.5	1.6	6.3
14	108.0	72.4	2.6	3.8
15	144.6	57.2	1.6	2.8
16	259.7	73.9	1.8	4.8
17	49.3	73.9	3.3	4.8
18	146.4	101.5	4.7	9.4
19	400.0	57.2	1.5	2.8
20	38.8	36.2	1.8	2.9
21	120.1	39.3	4.9	2.9
22	11.7	40.9	2.1	9.3
New York				
23	180.3	101.5	14.3	9.4
24	275.2	52.4	2.3	2.0
25	263.5	85.1	3.3	5.4
26	128.2	74.7	2.4	3.2
27	143.0	48.8	2.0	7.3
28	24.1	39.3	0.7	2.9
29	245.6	101.5	11.3	9.4
30	303.8	42.5	1.7	3.5
31	397.8	40.5	4.1	4.6
32	141.6	89.0	4.2	5.0

7. To date, has the assistance had any impact on your sales?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. No impact	13	36	40
2. Yes - increase	4	13	24
3. Yes - decrease	1	0	2

8. To date, has the assistance had any impact on your net income?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. No impact	13	39	37
2. Yes - increase	4	9	27
3. Yes - decrease	1	1	2

9. To date, has the assistance had any impact on the number of employees (full-time equivalent) you have?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. No impact	17	44	59
2. Yes - increase	0	4	4
3. Yes - decrease	1	1	3

10. To date, has the assistance had any impact on your business expenses?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. No impact	13	40	40
2. Yes - increase	1	3	8
3. Yes - decrease	4	6	18

4. Do you feel you generally had the financial resources needed to carry out the recommendations?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. Yes - always	3	6	13
2. Generally yes	2	6	13
3. Half yes/half no	2	7	14
4. Generally no	2	15	13
5. No - always	8	9	12
6. No recommendation made	1	7	1

5. In general, of how much use, if any, were the recommendations? Would you say they were of:

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. Very great use	2	7	15
2. Great use	4	8	11
3. Moderate use	4	8	21
4. Some use	2	6	7
5. Little or no use	5	14	11
6. No recommendation made	1	7	1

6. In general, to what degree did you actually implement the recommendation made by the counselor?

Would you say:

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. You implemented ALL of what was recommended.	2	1	3
2. You implemented MOST of what was recommended.	1	7	17
3. You implemented HALF of what was recommended.	5	4	14
4. You implemented SOME of what was recommended.	4	16	14
5. You implemented LITTLE or NONE of what was recommended.	5	15	17
6. No recommendation made	1	7	1



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

OFFICE OF THE ADMINISTRATOR

October 15, 1980

Mr. Henry Eschwege  
Director, Community and Economic  
Development Division  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. Eschwege:

Your examination of the Small Business Administration's EOL lending program is entitled "Most Borrowers of Economic Opportunity Loans Have Not Succeeded in Business." This title, and one of your main conclusions, strongly suggest that the program as a whole has failed. The SBA does not agree.

The report does properly discuss the high risk nature of EOL loans: new business in competitive industries, inexperienced entrepreneurs, low capital contributions, and marginal business locations. The following table describes the risk categories that both the private and public lenders deal with:

<u>Risk Category</u>	<u>Type of Loan</u>	<u>Approximate \$ losses to \$ disbursements</u>
1	Bank loans	2%
2	Finance Companies	6%
3	SBA 7(a) Guaranties	10%
4	SBA 7(a) Direct	15%
5	SBA EOL	34%

As expected, EOL loans are in fact the highest risk portfolio. This performance, however, cannot simply be dismissed as unacceptable, when the statute specifically targets high risk ventures. The key issue is, given the statutory direction, what results should be expected for a 5th tier risk category? Is a 15 percent success rate acceptable or not? The report implies 15 percent successful firms is not acceptable. What rate is?

The following is a brief summary of our feelings concerning the specific recommendations to improve the program performance.



## 11. Would you request assistance again?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. YES	7	16	35
2. Probably YES	3	9	9
3. Uncertain	1	3	5
4. Probably NO	1	4	6
5. NO	6	18	11

## 12. Would you recommend the assistance to someone else?

	<u>SCORE</u>	<u>SBI</u>	<u>Call con- tractor</u>
1. Definitely YES	10	25	41
2. Probably YES	5	15	17
3. Uncertain	0	2	4
4. Probably NO	0	3	0
5. Definitely NO	3	5	4

Note: Some borrowers did not respond to all questions.

Mr. Henry Eschwege

3

contents of your report. This information may assist the potential borrower to assess the desirability and risks attendant with starting a business or taking on greater financial obligations.

Sincerely,

*for H. D. Heiste, acting*  
A. Vernon Weaver  
Administrator

U.S. GOVERNMENT PRINTING OFFICE: 1980-O-341-843/370

(077890)



Mr. Henry Eschwege

2

1. More rigorous examination of loan packages: some example cases attest to the need for better application analysis. However, we doubt that a rigorous review of high risk situations will significantly affect the program output performance.
2. Change the goal system to successful businesses rather than loans made: SBA needs to focus more on the "results of lending" rather than lending itself. How this shift actually modifies current practices given the time lag before the results are known, is questionable.
3. Modify the waiting list system for loan applicants to accept best chances for success: the SBA agrees that this approach is preferable.
4. Use techniques such as initial payment grace period and graduated payment schedules to assist clients: these techniques may work but we believe they would not be much better than deferments and refinancings which your report says don't work.
5. Improve management assistance services: we believe that long term management assistance could possibly make substantial improvements in the success rate. Given the reluctance of loan clients to receive such assistance, the ultimate effectiveness may be nil.
6. Congress should change the structure of the loan program particularly with regard to rates: the SBA has offered a legislative proposal that will strengthen the overall minority lending program. Congress has not acted.

Perhaps one of the most useful changes SBA could make is to inform loan applicants of the historical success/failure statistics for the program as a whole, in other words, the

**AN EQUAL OPPORTUNITY EMPLOYER**

**UNITED STATES  
GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548**

**OFFICIAL BUSINESS  
PENALTY FOR PRIVATE USE, \$300**

**POSTAGE AND FEES PAID  
U. S. GENERAL ACCOUNTING OFFICE**



**SPECIAL FOURTH CLASS RATE  
BOOK**



"Minority--Depressed Area"--recommending approval for an Asian applicant doing business in Manhattan.

\* \* \* \* \*

"Principals are members of a minority group and loan is eligible under EOL criteria since business is located in a county of substantial and persistent unemployment"--recommending approval for black applicants reporting a family income of \$37,238 on an application dated December 20, 1976. Business was located in the New York City suburbs.

In our view, the social or economic disadvantage of the borrowers referred to above was not self-evident and should have been better explained. A careful consideration of "disadvantage" is particularly important for direct loans, since direct loan funds are limited and the acceptance of an ineligible applicant prevents an eligible applicant from receiving a loan.

The need to determine disadvantage is indicated by statistics we developed on the family incomes of borrowers who received EOLs in fiscal year 1978. According to SBA records, 245 of the these borrowers (out of 3,300 loans approved that year) reported family incomes of more than \$20,000, as shown in the following table.

Borrowers Reporting Family Incomes  
of More than \$20,000 Whose EOLs Were Approved  
in Fiscal Year 1978

<u>Family income</u>	<u>Minority owned</u>	<u>Not minority owned</u>	<u>Total</u>
\$20,001-\$29,999	111	68	179
\$30,000-\$39,999	22	20	42
\$40,000-\$49,999	10	4	14
\$50,000 and over (note a)	<u>5</u>	<u>5</u>	<u>10</u>
 Total	 <u>148</u>	 <u>97</u>	 <u>245</u>

a/Incomes in this category ranged up to \$80,000.