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SMALL BUSINESS

SBA Incurs Substantial Losses on Liquidated Loans

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our ongoing work, performed at your request, on the effectiveness of the Small Business Administration's (SBA) efforts to liquidate the collateral of defaulted section 7(a) general business loans. We are examining SBA incurred losses on liquidated general business loans--both direct and guaranteed--and the reasons for these losses. Our work is being performed on a statistical sample of loans that were made and placed in liquidation prior to 1989--the last year for which data was available when we initiated our review. The results of our work are only projectable to liquidation activities in three of SBA's ten regions--Chicago, Dallas, and Denver. In fiscal year 1989, these regions accounted for 44 percent of all outstanding liquidated loans and 46 percent of the total outstanding balance on liquidated loans. Because our work is ongoing, the information presented in this testimony is subject to minor revision.

In summary, SBA experiences significant losses when its general business loans are liquidated. During fiscal year 1989, the three SBA regions reviewed lost a total of $161 million on liquidated loans valued at $256 million. These losses were incurred primarily because insufficient collateral existed when loans were liquidated. Collateral was insufficient because SBA considers collateral of secondary importance in its loan-making decisions. As a result, collateral such as inventory and accounts receivable, the value of which often declines during the life of a business, is accepted for loans. SBA regulations require that loan collateral be adequate to reasonably protect the interests of the government. However, the regulations also state that lack of collateral cannot normally be the sole basis for disapproving a loan. SBA emphasizes the latter when reviewing loan applications.

Loan losses were also higher than necessary because SBA did not maximize recoveries on existing collateral. This occurred for several reasons. First, collateral was not identified, inventoried, and valued in a timely manner when a loan was placed in liquidation. Second, inadequate or no liquidation plans were prepared by SBA or private lenders. According to SBA, these deficiencies occurred because of shortages of personnel, time, or travel funds, and other higher priority duties. Finally, loan losses were higher than necessary because SBA operating procedures did not ensure that private lenders were maximizing recoveries on liquidated collateral. Most SBA operating procedures on liquidation were prepared in the late 1970s or early 1980s when nearly all liquidation actions were performed directly by SBA. However, private lenders currently service about one-third of the business loan portfolio. As a result, SBA's operating procedures have become outdated because they do not include guidance on monitoring actions SBA should take to ensure that private lenders are properly liquidating loans.

BACKGROUND

Section 7(a) of the Small Business Act of 1953 authorizes the general business loan program. Under this program, SBA provides direct loans, or guarantees private lender loans, to new or ongoing small businesses that are unable to obtain other financing. In administering this loan program, SBA has the difficult job of providing loans to borrowers who do not meet commercial credit standards while protecting the government's and, ultimately, the taxpayer's financial interests.

With an outstanding loan balance of over $11 billion as of March 31, 1991, the general business loan program accounts for over 60 percent of all SBA financial assistance to the small business community. Most of these outstanding loans--85 percent--are guaranteed loans. For these loans, SBA guarantees payment of outstanding principal and interest in case of loan default. The guarantee is for a specified percentage of the loan, not to exceed 90 percent.

SBA regulations require that all general business loans--whether direct or guaranteed--have adequate collateral to reasonably protect the government's interest. However, the actual amount of loan collateral SBA requires depends in part on other credit factors, such as repayment ability, and is determined on a case-by-case basis. Normally, SBA does not use inadequate collateral as the sole reason for disapproving a loan.

When borrowers fail to repay direct loans or guaranteed loans, the collateral provided for the loan may be sold--liquidated--to obtain loan repayment. SBA liquidates collateral for direct loans. However, collateral for guaranteed loans is liquidated by either SBA or the private lender who provided the guaranteed loan. For guaranteed loans, SBA and private lenders share in the collateral proceeds and any liquidation expenses incurred by the private lenders. The same standard operating procedures apply whether SBA or the private lenders liquidate the loans.

In addition to liquidating collateral, SBA or private lenders may pursue personal guarantees or obligations provided by the borrowers or others to repay the outstanding debt. Personal guarantors are individuals, usually the owners of the business, who pledge their own assets as security that the debt will be repaid. Pursuing personal guarantors can involve the sale of non business assets such as personal residences. However, in many cases, SBA uses compromise settlements in lieu of actual liquidation actions to obtain additional debt repayment.

As of March 31, 1991, SBA had approximately $1.2 billion, or 10 percent of its outstanding general business loans, both direct and guaranteed, in liquidation. Over the past ten years, the amount of SBA's portfolio that has been in liquidation has steadily decreased--from a high of about $1.8 billion in 1985 to its current level of $1.2 billion.

SIGNIFICANT LOSSES ARE INCURRED ON SBA LOANS

In fiscal year 1989, SBA incurred significant losses when its 7(a) general business loans were liquidated. Three SBA regions--Chicago, Dallas, and Denver--incurred estimated losses of a total of $161 million on liquidated loans valued at $256 million. In liquidating these loans, SBA incurred outlays or costs of $226.7 million while obtaining recoveries of only $65.7 million. The result was a 71-percent loss rate, or conversely, a 29-percent recovery rate.

Approximately $219 million, or 97 percent of the $226.7 million in costs associated with liquidating these loans, consisted of principal and interest paid to lenders on guaranteed loans, or outstanding direct loan principal and interest at the time of liquidation. The remaining costs were primarily for expenses such as the payment of taxes or the payment of prior lien holders.

Recoveries of $65.7 million came from two main sources--the sale of collateral, $47.7 million, and the pursuit of personal guarantors, $9.5 million. Because funds obtained from the sale of collateral were not enough to repay the outstanding debt, SBA had to pursue the assets of personal guarantors to increase recoveries.

Other miscellaneous recoveries totalling $5.5 million were obtained from such sources as the release of SBA liens for cash and SBA's share of liquid collateral such as bank accounts. Additional revenues that offset liquidation costs but were not considered loan recoveries, amounted to $3 million and included guarantee fees paid for obtaining an SBA loan and revenue from leasing collateral that SBA had acquired.

INADEQUATE COLLATERAL EXISTS WHEN LOANS ARE LIQUIDATED

SBA experienced substantial losses principally because insufficient collateral existed when defaulted loans were placed in liquidation. In the three regions reviewed, collateral was valued at $448.5 million when the loans were made. However, when these same loans were liquidated, the collateral was estimated to be worth $143.4 million--a 68-percent decrease. This decline in collateral value is due to three factors: (1) SBA considers collateral to be of secondary importance in it's loan-making decision process in order to provide funds to borrowers who cannot get credit elsewhere, (2) loan applicants sometimes overstate the value of collateral they pledge as security to help gain loan approval, and (3) SBA sometimes subordinates its claim to the borrowers loan collateral to assist financially troubled borrowers obtain additional credit from private lenders.

Collateral is of secondary importance in SBA's loan-making decision process. When reviewing a loan application, SBA emphasizes that the lack of collateral cannot be the sole basis for declining a loan. As a result, "soft" collateral, such as inventory or accounts receivable, is accepted for loans. However, such collateral often dissipates or significantly declines in value during the term of the loan. Therefore, there is often little collateral available if the loan is liquidated. For example, in October 1983, SBA guaranteed a $440,000 loan to a Texas oil distributor. At that time, collateral was valued at $560,000 ($130,000 for machinery and equipment, $259,000 for accounts receivable, and $171,000 for inventory). At liquidation in November 1986, an appraiser valued the remaining loan collateral at about $25,000. The accounts receivable and inventory collateral had dissipated during the course of the business. As a result, SBA incurred a loss of about $260,000 on this loan.

Another reason collateral declines in value is that loan applicants likely overstate the initial value of collateral they pledge as security to demonstrate that adequate collateral exists to gain loan approval. In the three SBA regions reviewed, applicants assigned their own value to real estate collateral in 67 percent of the loans and in over 90 percent of the loans for which other collateral, such as machinery and equipment, was offered.

Finally, the value of collateral that SBA has when a loan is placed in liquidation is less because SBA sometimes subordinates its lien, or its right to claim funds from the sale of liquidated collateral, to other lenders in order to assist financially troubled borrowers to obtain additional credit. As a result, loans that may have been fully collateralized at approval are undercollateralized at the time of liquidation. This situation significantly limits SBA's ability to recover the amount due to the government. For example, in August 1981, just before the planned liquidation of an Illinois furniture manufacturer's collateral, SBA and the private lender involved subordinated all of their collateral to another business on the condition that it loan up to $150,000 to the failing manufacturer. As agreed, this business provided about $150,000 in working capital to the furniture manufacturer, but the business still did not improve. In November 1981, the loan was placed in liquidation. The collateral was liquidated for about $93,000--all of which went to the business that loaned the manufacturer $150,000. No collateral proceeds remained for SBA or the original lender. SBA incurred a loss of approximately $300,000 on the loan.

RECOVERIES ON EXISTING COLLATERAL ARE NOT MAXIMIZED

Regardless of the sufficiency of collateral, SBA's efforts to liquidate collateral do not ensure maximum recoveries. In the three SBA regions reviewed, collateral at the time of liquidation was valued at $143.4 million. SBA's actual recoveries were $65.7 million, or about 46 percent of the collateral value. Low recoveries occurred for four reasons. First, SBA does not always identify, inventory, and value liquidated loan collateral in a timely manner, as required by its operating procedures. For 16 percent of the loans in the regions reviewed, neither SBA nor private lenders visited the business to identify and inventory collateral at the time a loan was placed in liquidation. In another 38 percent of the cases, this visit was not made until over 2 weeks after the loan was placed in liquidation. According to SBA, visits are not made, or not made in a timely manner, because of shortages of personnel, time, or travel funds, and other duties that were viewed as higher priority. Without timely identification, SBA does not know the status of its collateral, and it may be sold or disappear without SBA's knowledge.

For example, in September 1981, SBA guaranteed a $78,600 loan to a crop-spraying business for debt repayment, machinery and equipment, and working capital. In June 1986, the loan, which had an outstanding principal of $45,500, was placed in liquidation. When the loan was made, collateral securing the loan consisted of real estate, machinery and equipment, trucks and autos, furniture and fixtures, and accounts receivable valued at $95,000. When the loan was placed in liquidation, an appraiser hired by SBA valued the machinery and equipment at $14,900; however, a site visit was not made to identify, inventory, and protect any of the collateral. Subsequently, SBA discovered that the borrowers had moved out of state taking the machinery and equipment with them. SBA did not recover any of these assets. Because of prior liens, the real estate collateral also became valueless to SBA, which lost about $41,000 on this loan.

The second reason for low recoveries was that liquidation plans required by SBA operating procedures were not prepared for 25 percent of the loans in the regions reviewed. For the remaining 75 percent that had liquidation plans, 81 percent did not contain time frames for liquidation actions; and 69 percent did not contain estimated liquidation expenses. According to SBA district office officials, they do not always require liquidation plans or prepare plans for their own liquidations because of shortages of time and personnel. Liquidation plans are designed to establish a uniform and systematic means of action, including documenting important elements of a case, and establishing a basis for supervisory overview and control so that valuable time does not elapse without action being taken or taken haphazardly. Without an adequate plan, the liquidation process lacks direction, and SBA has no basis for controlling liquidation actions taken by private lenders.

Third, collateral recoveries are also not maximized because private lenders have limited financial incentive to maximize recoveries. Private lenders recovered approximately 25 percent of the value of collateral liquidated while SBA recovered approximately 68 percent. For defaulted loans, private lenders usually receive their guarantee payments from SBA before collateral is liquidated, and any proceeds lenders subsequently receive from the sale of collateral are minor compared with SBA's share. For example, if a loan is guaranteed for 90 percent, the lender will receive payment for 90 percent of the outstanding principal and interest but will then receive only 10 percent of any collateral recoveries. Thus, the lender has very little incentive to increase collateral recoveries.

Finally, collateral recoveries are not maximized because SBA's standard operating procedures do not detail what specific monitoring actions SBA should take to ensure that private lenders are properly liquidating loans. As a result, SBA's monitoring of lenders' liquidation actions is limited, and some actions are taken by lenders without SBA approval. For example, in December 1987, an SBA district office relied on a lender to liquidate the collateral securing a $103,000 loan made to a pet store owner. At the time of liquidation, the loan was secured by supplies, fixtures, and inventory originally valued at $83,000. After submitting a liquidation plan, the lender took proper actions to move small live animals, such as puppies and kittens, to another pet store. However, the pet store's fish remained on the premises, and the lender paid a law firm, which had been handling the liquidation action for the lender, almost $1,000, (at a rate of $40 per hour) to feed the fish and maintain them over a 2-month period. Because of inadequate monitoring, SBA did not become aware of these charges until the lender submitted a detailed invoice for reimbursement of expenses. The lender was reimbursed about $3,000 for payments it made to the law firm, including the $1,000 to feed the fish. SBA incurred an estimated $49,000 loss on this loan.

COLLATERAL MANAGEMENT IS MINIMAL

Finally, Mr. Chairman, you asked us to determine the level of effort SBA expends on loan collateral management. Collateral management usually includes such activities as assessing the extent of protection, maintenance, and repairs necessary to preserve the acquired collateral's resale value. Collateral management activities are minimal because SBA and private lenders usually do not take physical possession of collateral. For three major types of collateral--real estate, machinery and equipment, and inventory--physical possession was taken only about one-third of the time. These three types of collateral accounted for 96 percent of the $143.4 million total value of collateral at liquidation.

However, total management expenditures for all collateral was about $516,000 or about 1 percent of the total value of acquired collateral.

Often, there is little collateral for SBA to manage because it is often missing or viewed by SBA as not worth pursuing. For example, in April 1984, SBA guaranteed a $155,000 loan to the owner of a building foundation drilling company. Collateral at the time the loan was made was valued at about $169,000. When the loan went into liquidation in October 1986, collateral consisted only of real estate valued at about $9,000. Machinery and equipment originally valued at $129,000 had been completely worn out by the business or had disappeared. SBA abandoned the real estate because it did not believe it could sell the property. SBA incurred an estimated $137,000 loss on this loan.

When SBA does acquire collateral, the time it takes to obtain possession depends on the method used. For non-real-estate collateral, possession is frequently obtained by "peaceful possession"--the owner willingly gives SBA the collateral. If a borrower will not voluntarily give peaceful possession, judicial means, which are much more time-consuming, must be used. For real estate collateral, SBA and other lenders use foreclosure or voluntary conveyance to obtain possession. In voluntary conveyance, the borrower voluntarily transfers the property title to the lender. Foreclosure involves the forced sale of collateral used as security with the proceeds being applied to the creditors in order of lien position. Again, as with non-real- estate collateral, foreclosure proceedings take significantly longer. For example, if SBA forecloses to obtain possession of real estate, the average time elapsed is 668 days; but if the owner voluntarily conveys real estate possession to SBA, the average time is 287 days. In the regions reviewed, SBA had to use foreclosure to acquire real estate collateral in 69 percent of the cases. About 90 percent of all non-real-estate collateral was acquired through peaceful possession.

CONCLUSIONS

By providing loans to high-risk borrowers SBA inevitably will lose money on some of its loans. Nonetheless, we believe SBA's current efforts to minimize losses to the government are inadequate. Much more can be done. Specifically, we believe actions such as:(1) improving the valuation of collateral when loans are made or guaranteed; (2) identifying, inventorying, and valuing collateral in a timely manner at liquidation; (3) ensuring that liquidation plans are prepared that specify liquidation steps, time frames, and estimated costs; and (4) revising SBA standard operating procedures to provide for adequate oversight of private lenders' liquidation actions will improve recoveries when SBA needs to liquidate loan collateral.

In addition, we believe that it makes sense to require stronger collateral, in amounts that reflect anticipated declines in value, at the time a loan is made or guaranteed. For example, collateral such as accounts receivable and inventory could be valued at something less than full value because these types of collateral usually dissipate during the life of a loan. Such a change would enable SBA to continue to provide assistance to small businesses while at the same time better protect the government's and, ultimately, the taxpayer's financial interests.

Our final report, which we plan to issue to you this summer, will include appropriate recommendations to correct deficiencies in SBA's loan collateral recovery efforts.

Mr. Chairman, this concludes my statement. I would be glad to respond to any questions that you or Members of the Committee may have.