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United States Senate
COMMITTEE ON THE BUDGET
WASHINGTON, DC 20510–6100

April 2, 2014

The Honorable Maria Contreras-Sweet
Administrator
U.S. Small Business Administration
409 3rd Street SW
Washington, DC 20416

Dear Administrator Contreras-Sweet:

Encouraging lending to small businesses is one of the primary purposes of the Small Business Administration (SBA). SBA's main program to achieve that goal is the flagship 7(a) loan guarantee program. There are a number of questions about the success of the SBA in this endeavor.

The loan guarantee program rests on the premise that in the free market, some small businesses are denied adequate credit at a reasonable rate because the lenders may overestimate the risk associated with the borrower. By guaranteeing a portion of a small business loan, the government takes on some of the risk and gives lenders an incentive to offer loans to individuals whom they would otherwise overlook as worthy borrowers. This model requires both that loans be extended to businesses that cannot get credit elsewhere, but if given a loan, the business will survive and prosper.

Under the SBA's 7(a) program, businesses which meet a very limited number of requirements, such as operating for profit, having sound business purposes, and not being able to get credit elsewhere are potentially eligible for a loan, not to exceed $5 million.[1] The average 7(a) loan in fiscal year 2012 was $337,730. A large share of these loans are guaranteed by the taxpayer.[2]

I am concerned that SBA, in some instances, has not met the high standards required in providing loan guarantees. Default rates on 7(a) loans are representative of this. Veronique de Rugy, senior research fellow at the Mercatus Center, has written that the SBA low default rate claim is misleading. First, when organized by cohorts, SBA

[1] SBA.gov, "7(a) Loan Program Eligibility," available at http://1.usa.gov/1gU0SAL.

[2] SBA guarantees 85 percent of loans up to $150,000 and 75 percent of loans in excess of $150,000, with a maximum exposure of $3,750,000.

default rates are higher than the ones advertised by the SBA (2007 SBA data shows 7.4 percent in 2005 as opposed to 1.5 percent for FDIC-insured banks or 4.3 percent for credit cards).[3]

Second, she notes that the high cost of default can be seen in the SBA outlays. In fiscal year 2011, the agency requested $1.5 billion in discretionary outlays.[4] However, total outlays, which include projected payouts for defaults, were $6.2 billion. In the past, requested outlays were closer to $1 billion. Also, the gap between that request and actual outlays used to be much smaller, but the agency has suffered increased losses in recent years on its guarantees. How this trend will evolve depends on the economy and whether default rates on SBA loans continue to increase. At the time the article was written in 2012, outstanding loans guaranteed by the SBA—and federal taxpayers—total about $92.9 billion. This is of no comfort to the taxpayers.

An April 2013 investigative report about the SBA by the *Dayton Daily News* reveals some concrete examples of the program's higher-than-publicized default rate. As the piece notes, "the program has cost the taxpayers $1.3 billion since 2000 on defaulted loans."[5] The default rate of certain franchises is of real concern: "Operators of national franchises like Quiz-nos and Cold Stone Creamery collectively received millions of dollars in loans through the program despite extensive default histories by the franchises." The investigative report highlights the fact that more than 1 in 5 loans, no longer active since 1990, were in default, costing the taxpayers $8.6 billion.

The problems highlighted in the *Dayton Daily News* have been confirmed by reports of the SBA Inspector General. According to recent reports from the SBA IG, the SBA, among other things, has failed to properly disclose improper payments, made improper loans of $869 million under the American Recovery and Reinvestment Act (the stimulus), and paid loan guarantees when it was incorrect to do so. In a report issued earlier this year, the IG examined nine perceived risk loans and found that three "were not originated and closed in accordance with SBA's rules and regulations… [This] resulted in inappropriate or unsupported disbursements of approximately $3.1 million."[6] The noncompliance involved questionable eligibility, inadequate assurance of repayment ability, and equity injection issues.

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[3] Veronique de Rugy testimony before the Senate Committee on Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, available at http://bit.ly/1gU1Kp4.

[4] Mercatus Center blog post, "The Small Business Administration: What Cost to Taxpayers?", available at http://bit.ly/1gU2F8X.

[5] *Dayton Daily News*, "Taxpayers paid $1.3B to cover bad business loans," available at http://bit.ly/1gU5qXR.

[6] Inspector General Audit Report 14-09, available at http://1.usa.gov/1gU6cnN.

There are obviously a number of factors that cause businesses to fail and default on a loan. However, it is worth noting that the SBA guarantee itself might also contribute to the high number of defaults in certain categories of the 7(a) loans program. The guarantee takes a substantive risk away from the bank making the loan (indeed, that is the whole point of the SBA loan guarantee) and very well could provide incentives for some banks to cut corners through the underwriting process. This is what economists call moral hazard and could have manifested itself with lenders being less than careful in their decisions to extend SBA loans.

The SBA must be aware of this trend, which has often been reported, and should try to address the issue by punishing less than scrupulous lenders. It does not appear to. For instance, in a July 13, 2011 report on Huntington Learning Centers, the IG found that Banco Popular, a preferred SBA lender, "did not adequately assess borrower repayment ability when originating... loans."[7] The IG found that "the lender disregarded relevant and available data, which indicated that the franchises' revenue projections were unreasonable... Had the lender complied with SBA's requirements to use and assess the feasibility of realistic projections, the 12 loans should have been declined." It is my understanding that Banco Popular remains qualified to approve SBA loans and that despite a high default rate, Huntington Learning Centers remain capable of receiving SBA loans.

It is difficult to comprehend how a loan is properly made where default occurs before the borrower makes one payment, but according to the *Dayton Daily News*, this is not an unusual occurrence. According to William Bruce, president of the American Business Brokers Association, more than 100 franchises with a minimum of 10 loans had a default rate of 40 percent or higher for the 10-year period ending in September 2011.[8] The franchise Wings-N-Things has an astounding 94 percent default rate.

Unfortunately, considering how lucrative SBA loans can be for SBA-certified banks, they may not have the incentives to rectify this moral hazard. The SBA guarantees 75 to 85 percent of the value of loans made in the flagship program. The banks then boost their earnings by selling the risk-free portion of the loans on a secondary market, making a nice profit in the process. If the borrower defaults on its loan, the lender still makes a profit while taxpayers shoulder the cost of the default. This is a good example of a program that appears to privatize profits and socialize losses.

I believe that SBA could develop better business practices to reduce the number of defaults and would like to know how you plan to achieve the type of success merited through the use of taxpayer funds. To this end, please respond to the following:

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[7] Inspector General Report 11-16, available at http://1.usa.gov/1gU76AE.

[8] William Bruce blog post, "Best and Worst Franchises Listed by SBA Loan Defaults," available at http://bit.ly/O8WbX8.

1. Please provide the default rate per cohort in the 7(a) program for the last 10 years data is available, listing each year separately.
2. Please provide the criteria SBA lenders are required to ensure borrowers meet, prior to extending a 7(a) loan.
3. Please explain what criteria SBA uses to measure the performance of 7(a) loans and the loan program.
4. Assuming no default, please provide the average return per investment to the SBA on 7(a) loans in the following amounts: $50,000; $100,000; $250,000; $500,000; $1,000,000; $2,500,000; and $5,000,000.
5. Assuming no default, please provide the average return per investment to SBA lenders on 7(a) loans in the following amounts: $50,000; $100,000; $250,000; $500,000; $1,000,000; $2,500,000; and $5,000,000.
6. Please provide the number of 7(a) loans and amounts for the last five years data is available, where no payment was made on the loan prior to default. If the loan was made to a franchise, identify the franchise. Also, please provide the name of the institution extending the loan.
7. Assuming default where 10 percent of the loan is repaid, please provide the amount of actual loss to the SBA for 7(a) loans in the following amounts: $50,000; $100,000; $250,000; $500,000; $1,000,000; $2,500,000; and $5,000,000.
8. Assuming default where 10 percent of the loan is repaid and the guarantee is in place, please provide the amount of actual loss to the SBA lender for 7(a) loans in the following amounts: $50,000; $100,000; $250,000; $500,000; $1,000,000; $2,500,000; and $5,000,000.
9. Please provide the percentage and dollar of amount representing the total share of small business 7(a) loans guaranteed by the SBA.
10. Please provide the percentage and dollar amount representing the total share of small business 7(a) loans to minorities and women backed by the SBA.
11. Does the SBA believe that without action from Congress, it has the authority to shift more of the financial risk to lenders participating in the 7(a) program? If not, please explain whether or not such authority would be beneficial.
12. The SBA has previously removed lenders from participating in the 7(a) program. Please provide a list of the lenders removed, the date they were removed, and the reason they were removed. If any of these lenders have been reinstated, provide the date of reinstatement, the reason for reinstatement, and the charge off amount SBA covered on the lender's behalf.
13. Does the SBA believe that lenders would take more care in issuing loans if guaranteed loans were not transferrable?

14. Please explain why the SBA does or does not review all loan applications prior to providing capital to the lender for purposes of making a loan.
15. Please explain whether or not the value of an SBA loan is decreased based on the use of government capital.
16. Please provide information on how the SBA decides to remove a lender from the program and whether there is a cut-off rate for lenders who produce a certain number of loans that default.
17. Please explain whether or not the SBA has excluded certain franchises because of high default rates, and provide the percentage of defaults necessary to exclude a franchise. If the SBA does not exclude franchises based on default rate or otherwise, please state whether the SBA believes it has the authority to do so.

In this time of record debt, every government program must meet high standards for efficiency and effectiveness, including the SBA.

Please have your staff provide this information both in hard copy and in an electronic, searchable format no later than May 7, 2014, to William Smith on the Senate Committee on the Budget. If you have any questions, please contact me or have your staff contact Mr. Smith at (202) 224-0642, or William_smith@budget.senate.gov.

Very truly yours,

Jeff Sessions
Ranking Member

JS:ph