OVERSIGHT OF THE SMALL BUSINESS ADMINISTRATION'S FINANCE PROGRAMS

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BEFORE THE

SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS

OF THE

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HOUSE OF REPRESENTATIVES

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THURSDAY, MARCH 9, 2006

HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Subcommittee met, pursuant to call, at 10:30 a.m., in Room 2360 Rayburn House Office Building, Hon. Jeb Bradley [Chairman of the Subcommittee] presiding.

Present: Representatives Bradley, Chabot, Millender-McDonald, and Velazquez (Ex Officio).

Also Present: Representatives Moore and Sherman.

Chairman BRADLEY. Good morning. I am going to open this hearing and welcome all of you to this hearing on the Tax, Finance and Export Subcommittee of the House Committee on Small Business. I am pleased to be working closely with my colleagues—I think they will arrive here shortly, hopefully—as we review the current state of the finance programs of the Small Business Administration. And I look forward to hearing the recommendations made by our witnesses in this regard. That said, I would like to thank our distinguished witnesses for taking the time to appear before us today.

Access to capital is a vital element in the success of any venture. And the knowledge of where to find such resources is equally essential. Accordingly, one of the key roles of the Small Business Administration is to provide financial assistance to American small businesses.

Small businesses are responsible for more than half of the United States' gross domestic product, and the finance programs available at the SBA are vital to the development and expansion of those small businesses. SBA financial assistance is delivered through investment programs, loan programs, and bonding for contractors, among other approaches. It is through these programs that small businesses are able to obtain the means to grow, create more jobs, increase revenue, and help strengthen our economy.

Over the years, the SBA and its methods of assistance in the strengthening of the small business sector of our economy have undergone changes and improvements. Today we have the opportunity to hear the comments and recommendations of those who are on the front line of these programs in order to better understand the demands of the small business sector and to continue our support in the most efficient and economical manner possible.

The President's budget for fiscal year 2007 funds small business lending at $28 billion. $17.5 billion of that funding would go to guaranteed loan volume under the 7(a) loan program.

The section 504 loan program, which provides guaranteed loans for fixed assets, such as land, equipment, and buildings, would receive $7.5 billion. And guaranteed long-term loans for venture capital investments in small businesses as a supplement to the capital of small business investment companies would be allocated $3 billion.

Congress must continue to enable small businesses to have access to the capital needed to expand and prosper. The input of those working closely with these small businesses is vital to this committee as it moves forward with the SBA reauthorization. And with your testimony today, we can help create an environment that fosters the growth and development of American small businesses.

I am looking forward to hearing the testimony from our witnesses here today. And I look forward to their thoughts on this extremely important topic. However, before we do so, I would like to recognize our ranking member of this Subcommittee, Mrs. Millender-McDonald. And I know that Congresswoman Velazquez will be here shortly. And she will have an opening statement, too. And I will recognize her when she gets here.

Thank you.

[Chairman Bradley's opening statement may be found in the appendix.]

Ms. MILLENDER-MCDONALD. Mr. Chairman, thank you so much. And good morning to all of you. I am pleased to join with the Chairman and those members who will be finding themselves into this committee room today as we discuss an issue of great importance to our nation's entrepreneurs. And that is access to capital.

For budding small business owners, a five-year plan is an essential step towards building a business. This forward-thinking planning sets a strong foundation and demonstrates a commitment to success.

Unfortunately, it has been five years since the SBA has shown that same commitment to America's businesses in the form of a new reauthorization plan. Instead, every year we have seen force and have been forced to fend off cuts in the budget without any improvements to the SBA financial programs that our nation's entrepreneurs so desperately need.

In our discussion today, I want to bring forth new ideas that we can use to update and improve our nation's entrepreneurs access to affordable capital. In today's economy, securing affordable capital is one of the most important components in growing a successful small business. Yet, many small business owners have difficulty qualifying for traditional bank loans. All too often, they are forced to use various methodologies of financing, such as credit cards and personal loans, to fund their business ventures. Because small business owners cannot access capital in the same way that large businesses can, it has been Congress' responsibility to ensure that there are special financing options geared to meet their specific needs.

This is why it is so critical that we show a commitment to America's small businesses by enhancing and strengthening SBA's fi-

nancing programs. These initiatives, including the 7(a), the 504, new markets venture capital, and SBIC programs, fill an important role. These initiatives fill a financing gap for small firms by making loans on great ideas that probably would not have been looked at twice by traditional banks. By bridging gaps in the capital markets, these programs have more than proven their effectiveness over the years.

In fact, since 1953, nearly 20 million small businesses have received direct or indirect help from one or another of the SBA programs. In turn, the agency's programs have become the government's most effective instrument for economic development: creating jobs and providing stability during times of uncertainty.

These programs are especially helpful for women, minorities, and individuals in low-income communities that often face additional barriers in accessing capital. Their entrepreneurial success can greatly assist in uplifting their local economies. This is where special initiatives, such as SBA's microloan programs, come in.

The microloan program assists under-represented small business owners with loans that they otherwise would not be able to attain, even through the SBA 7(a) program. Last year alone, the microloan program provided entrepreneurs with $20 million in loans and helped our budding entrepreneurs progress from poverty to successful business ownership.

Still, over the past three years, the Bush administration has proposed eliminating this vital program. This program deserves to be supported, not dismantled. Clearly, access to capital is access to opportunity for our nation's entrepreneurs. If we sincerely want our nation's entrepreneurs to have the ability to secure capital, spur economic development, and create job opportunities, we must support the SBA programs with the long-term initiatives that will ensure their survival. This is why it is so important that we are talking at this time today to review the success of SBA's financing programs.

Today we will hear testimony from a variety of organizations and individuals representing the various small business programs.Drawing upon their experiences in helping our nation's entrepreneurs succeed, I am hopeful that their useful insight and recommendations can be used to improve the SBA programs and ensure the success of our nation's small businesses.

Mr. Chairman, it is clear that our nation's entrepreneurs have done an outstanding job of creating jobs and spurring economic growth. In order to continue their good work, we must be empowered and they must be empowered with all of the necessary tools; most importantly, affordable and available capital. If we want our entrepreneurs to continue serving as America's main economic drivers and job creators, it is integral that we form a long-term vision for their vital initiatives.

Mr. Chairman, I thank you so much for this hearing. And I look forward to the testimony of all of the witnesses who are here today.

[Ranking Member Millender-McDonald's opening statement may be found in the appendix.]

Chairman BRADLEY. Thank you very much, Mrs. Millender-McDonald.

Now I would like to yield as much time as you would like to consume to the ranking member of the committee, Congresswoman Velazquez. Thank you.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I really appreciate it. I also would like to thank Congresswoman Millender-McDonald for letting me sit in on this hearing. And I appreciate all of the work you are doing on this issue.

The President never misses an opportunity to proclaim that small businesses are a priority for this administration. Yet, time and time again, his policies simply do not back up his rhetoric. No place is this more apparent than in how SBA access to capital programs are being run.

Ensuring loans are affordable and that relief from rising capital costs is available are both critical in helping entrepreneurs to remain a driving force in today's economy.

While this administration has talked the talk, they have failed to walk the walk. For evidence of this, one only needs to look at the 7(a) program, the largest long-term lending initiative for small businesses.

Under the current administration, lending has grown much more costly and harder to obtain. In the past two years alone, costs on borrowers have doubled and lender costs have risen by 118 percent, making it increasingly difficult for small businesses to receive the capital they need.

As if that was not bad enough, in the F.Y. 2007 budget, the administration plans to further increase the cost of this program by proposing to raise current fees and creating a whole new set of fees. This would make the program even more costly, only pushing 7(a) and other lending programs further out of reach.

It has become very clear what type of effect these poor policy choices are now having. Lending was down by $300 million last quarter. When you factor these new costs, coupled with the rising interest rates, it is apparent that the trend of less and less capital going into the economy is only going to continue.

Traditional capital is not the only place this administration is failing our nation's entrepreneurs. For the last year and a half, SBIC's participation in security programs has been shut down due to mismanagement and poor policy decisions. However, the agency has yet to propose a new plan to reopen the program.

I think this speaks to the level of commitment that exists for this nation's small businesses. When you consider this decision in light of the fact that currently less than one percent of venture capital goes to minority businesses, it really makes you wonder where the administration's priorities are.

Compounding this is the proposal to abolish one of the most significant policies affecting low-income entrepreneurs: the microloan program. So much for compassionate conservatism. It is just like this administration to put politics in front of good policy. They continue to call for an elimination of the microloan program when they do not have the support of one single member of the House or Senate.

This program makes loans to entrepreneurs that are unable to get a traditional loan due to inexperience with credit, lack of access, or the need for an ongoing technical assistance. Clearly this

initiative is crucial for the thousands of entrepreneurs that have no other means of financing available to them.

By terminating the microloan program and not reopening the participating securities program, the administration is turning its back on start-ups of all types that need access to seed capital. Blocking access to start-up financing impedes the formation of new businesses and prevents the job growth that is still netted in so many parts of this country.

Small businesses are the measured driver of this economy, but it is crucial that we work together to make sure that they have the tools needed to thrive and be successful. I don't see the administration coming to the table with the interest of small businesses in mind.

This agency's proposals repeatedly represent OMB's interest and not those of our nation's entrepreneurs. Small businesses deserve better than this.

Thank you, Mr. Chairman.

[Congresswoman Velazquez's opening statement may be found in the appendix.]

Chairman BRADLEY. Thank you very much.

And now I would recognize Congressman Sherman for purposes of an introduction.

Mr. SHERMAN. I am here to introduce Grace Mayo of the Chatsworth Community Credit Union. She is the president and chief executive officer of that credit union. And that credit union has really shown among valley organizations in my district for its dedication to the community. They're building a new building, which will have a community room.

Grace herself is involved in virtually every charitable and business organization in the valley. And she has taken a lead in the credit union movement and will be particularly able to tell this Subcommittee how credit unions can be involved in lending to small business.

So I introduce to you a real valley girl who knows her stuff, Grace Mayo.

Ms. MAYO. Thank you, Congressman.

Chairman BRADLEY. Thank you very much.

Now I'll turn to the panel. Our first witness is Mr. Michael Hager, who is the Associate Deputy Administrator for the Office of Capital Access of the SBA.

Our second witness is Mr. Lee Mercer, the President of the National Association of Small Business Investment Companies here in Washington.

The third witness is Mr. Anthony Wilkinson, who is the President and CEO of the National Association of Government Guaranteed Lenders in Stillwater, Oklahoma. Thanks for coming so far.

The fourth witness is Mr. Kurt Chilcott, Chairman of the Board of the National Association of Development Companies in McLean, Virginia.

Our fifth witness is Ms. Lynn M. Schubert, President of The Surety Association of America here in Washington.

And our last witness, as Congressman Sherman introduced, is Grace Mayo, President and CEO of Telesis Community Credit Union in Northridge, California. Thank you for coming so far.

So first Mr. Hager. Thank you.

STATEMENT OF MICHAEL HAGER, OFFICE OF CAPITAL ACCESS, U.S. SMALL BUSINESS ADMINISTRATION

Mr. HAGER. Well, thank you Chairman Bradley, Ranking Member Millender-McDonald,—

Chairman BRADLEY. If I could just interrupt? I should have started out by saying that because there are six witnesses in this panel and we want to make sure we get to questions, if you could do your utmost to try to stay within the five-minute rule, summarize? And then we'll be able to have more questions. Thank you.

Mr. HAGER. Thank you again for inviting me to testify before this committee regarding the SBA's reauthorization and the fiscal year 2007 budget for capital access programs. I am here this morning to talk about the SBA's incredible loan growth over the last five years, our actions to manage that growth, and our actions to manage the risk associated with that growth.

We have significantly increased our loan volume since 2001, more than doubling the number of 7(a) and 504 loans, doing so at zero additional cost to our subsidy rates to our taxpayers.

The President's fiscal year 2007 proposal provides, as you indicated, Mr. Chairman, $28 billion for SBA's refinancing of small businesses. In 2005, we served more businesses than ever before in our two major loan products. And we increased the numbers of loans funded by 22 percent in one year, moving from 80,000 in 2004 to 98,000 loans in 2005. During this period, lending to minorities increased by 23 percent and to women-owned businesses by 39 percent in terms of the number of loans funded.

To maintain the zero subsidy cost of these programs, minor fee changes will need to occur. And in the 7(a) program, the guaranty fee will increase slightly in 2007, from 54.5 basis points to 55 basis points, an increase of only one-half of one basis point.

We are especially pleased that the performance of the 504 program permits the SBA to lower the ongoing fee from 19.8 basis points to 1.8 basis points.

The SBA is seeking authority to cover more of its expenses through fee authority that will enhance the ability of the SBA to properly manage our programs. First, we are requesting authority to charge fees to certify development companies, the CDCs, in the 504 loan program to cover the cost of oversight. We have the authority for the 7(a) program and are requesting comparable authority for the 504 loan program.

Second, we are proposing the addition of an administrative fee to cover the cost of making loans of more than one million in the 7(a), 504, and SBIC programs. Now, please, this is separate from the subsidy rate, which exclusively considers the credit and potential losses of a loan guaranty program. Again, it's separate from that.

Based on SBA's 2005 experience, only 3 percent of 7(a) loans will be impacted. And under the 504 program, only 15 percent of those loans would be impacted.

Managing the tremendous growth of our loan portfolio is another key priority. Many improvements have been made over the past several years by centralizing lending functions. We have centralized 7(a) loan guaranty purchase and liquidation as well as 504

processing. We are moving toward centralization of the 504 liquidation and purchase components and the remaining 15 percent of 7(a) loan processing.

We now process 504 loans in two to three days, as opposed to previous time frames of up to six weeks. We also process guaranty purchase requests in all-time record time. In order to streamline this process of becoming a preferred lender, we are also looking at setting up a national point of contact for PLP lenders, replacing today's 68 points of contact. This move will reduce processing time from up to 8-9 months to less than 30 days.

We are constantly looking at ways to improve lending functions and better manage operations. A major initiative underway is to streamline the liquidation process. The proposed changes will give the agency more flexibility in managing its loan portfolios that are being liquidated. If finalized, these regulations will give SBA more flexibility to sell purchased guarantied loans using asset sales. And we are also proposing that lenders fully liquidate loans prior to requesting purchase. This would be an essential component if we are to maximize our resources.

We also need to manage the risk in our loan portfolio. We have a state-of-the-art loan and lender monitoring system provided by Dun and Bradstreet that incorporates the best practices of the financial industry. As part of the monitoring system, we have developed and are introducing the concept of lender risk ratings using both historical performance and projected future performance and are able to evaluate every SBA lender on a quarterly basis.

Lender risk ratings also allow us to prioritize on-site reviews so those with the poorest performing lenders are reviewed first and if ratings decline, attention can quickly be focused on those lenders.

Now, in conclusion, we are very proud of the growth of the programs and our efforts to ensure that this growth is managed effectively. Today SBA is helping more small businesses meet their financial needs than ever before and at no subsidy cost to the taxpayer.

Let me say again we have three priorities in capital access: continuing our loan growth, managing that growth, and managing the risk of that growth.

Thank you for your time today, Mr. Chairman, Ranking Member, and members of the Committee. I will look forward to the Q and A time.

[Mr. Hager's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you, Mr. Hager.

I recognize Mr. Mercer and remind everybody to try to stay within that five-minute time frame. Thank you.

STATEMENT OF LEE MERCER, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. MERCER. Thank you, Chairman Bradley, Ranking Member Millender-McDonald, and full committee Ranking Member Velazquez, members of the committee.

I appreciate the opportunity to appear today to discuss the status of the SBIC program. My written testimony speaks for itself. I believe it addresses all of the issues of relevance. And I will not re-

peat that testimony here in detail. Rather, I would like to make the following points.

The SBIC program is one of the most effective programs in the world, in the world, in stimulating investment in the smallest of fast-growing companies called gazelles by many experts that are the foundation of America's economic structure. The program has been studied by virtually all foreign countries interested in stimulating growth in their small business sectors and has been replicated in one form or another by many.

At the current time, the Bush administration is bent on eliminating the equity investment portion of the program, the participating security program, which represents more than 55 percent of investments made last year, and has proposed an ill-considered, ill-defined, and damaging new fee for the subordinated debt investment portion of the program, the debenture program.

With regard to the participating security program, the administration's actions ignore the demonstrated need for the program, a need established in the 2005 hearing held at the full committee level last year.

The participating security program still exists in law, though no new funds have been licensed since the close of F.Y. 2004. However, the administration has kept the industry and this committee jumping through hoops trying to find a replacement structure because it claims that the underlying security, the participating security, as an equity security does not meet the requirements of the Federal Credit Reform Act for the purposes of a credit subsidy program that can be scored for appropriations purposes. Without that qualification, the program would need a dollar for dollar appropriation, obviously a non-starter.

Now, in January, the administration states in writing that participating securities are debt securities and specifically requires SBICs to list those securities as debt in their financial statements. It cites the Financial Accounting Standards Board, FASB, as authority for this position.

It seems to me that the administration cannot have it both ways. And if the participating securities are debt securities, we can restart the program this year by making simple adjustments in the fees and cash flows to bring the subsidy rate to zero. If need be, Congress, the author of the Federal Credit Reform Act, can state in the reauthorization bill that a participating security is a debt security for all purposes of that act.

If the participating security program is not restarted one way or another, whether, as I have suggested, which is the easiest way, or through passage of H.R. 3429 or a like bill, the Bush administration will have succeeded in cutting the SBIC program by more than half and will have eliminated all of the SBIC money flowing to start up early stage companies. I do not believe that that will be a legacy to be proud of.

We hope the committee will hold the administration's feet to the fire this year so we can solve the problem in a way that will benefit the small businesses that depend on the program for equity capital, the precursor to all growth.

To return to the matter of proposed fees for the debenture program, for all the reasons stated in my testimony, the proposal is

ill-considered and will do significant damage to individual SBICs, in particular, and the program in general. It attempts to pass costs to SBICs that they have no ability to control. Who has the ability to control those costs? That's a question we would like to have answered.

SBA cannot even tell us to this date how the fee would be imposed. The Investment Division was not involved in developing the fee. So we hope and urge the committee to oppose the budget proposal in that regard.

Finally, I believe our suggestions for the reauthorization bill are self-explanatory. We have raised them in the past. We look forward to working with the committee to determine how those proposals might be adopted to further improve the SBIC program.

Thank you for your attention. I will be happy to answer questions at the appropriate time.

[Mr. Mercer's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you very much.

Mr. Wilkinson?

STATEMENT OF ANTHONY WILKINSON, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Thank you, Mr. Chairman, Ms. Millender-McDonald, Ms. Velazquez, Mr. Chabot. Thank you for the opportunity to testify today. I'm just going to quickly summarize my written statement.

The budget request for 2007 touches on just a few items. Number one, the administration requests a $17.5 billion program level for 2007. We had requested $18 billion, just a little more than they had in their budget proposal. We find the 17.5 to be acceptable.

The budget request also increases the lender fees up to the statutory maximum. It's not a big increase, going from .545 up to .55, but the real point is that we are now at the statutory maximum for that fee and it cannot be increased any further.

The administration also proposes an administration fee. This is something we are adamantly opposed to. It is, in effect, a step towards a government-sponsored enterprise. And, most broadly stated, if we want to move in that direction, we should have proper debate before we start covering what truly is a government function at this point.

The other thing that shows up in the fiscal year 2007 budget request is the fact that we have a declining average guaranty fee in our program. We are making more and more small loans, which is a good thing. What is missing from the mix is fewer and fewer large loans. The large loans, in fact, subsidize the cost of the smaller loans. What has happened over the last five years is that the dollar volume of small loans has gone from 18 percent up to 25 percent. Those loans pay a much lower guaranty fee than do larger loans.

To stop this trend, we are proposing an increase in the maximum loan size from $2 million up to $3 million and an increase in the maximum guaranty amount up to $2.25 million. We think this will be a way to stop the trend of a declining average guaranty fee. And if we don't stop that trend, we are going to be faced with some tough decisions in the fiscal year '08 budget that would include

raising fees even further on borrowers and lenders, something we would not like to see happen.

The rest of our legislative proposal is to be able to use the alternative size standard that is available in the 504 and the SBIC programs. We have requested a national PLP program. This is something that the SBA has agreed to. And we are working to get that done.

And, lastly, we had the authorized level of $18 billion.

That summarizes the written testimony. And I would be happy to answer questions.

[Mr. Wilkinson's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you very much

STATEMENT OF KURT CHILCOTT, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

Mr. CHILCOTT. Again I would first like to thank Chairman Bradley, Ranking Member Millender-McDonald, and the Committee Ranking Member Velazquez, as well as the other members of the Committee on Small Business for your continued support of the CDC industry and the SBA 504 program.

I represent NADCO as its chair of the board and also CDC Small Business Finance based in San Diego, where I serve as President and CEO. I am going to address two things with you this morning: the proposed SBA budget for 2007 and then NADCO's legislative proposal.

NADCO has two concerns regarding the proposed budget. First of all, the authorization ceiling that has been set of 7.5 billion is too low. We have experienced 30 percent annual growth in this program the last three years. We expect that to continue. And we need a larger authorization to accommodate that growth.

If we meet that authorization and exceed it during the year, it means the program is shut down, rationed, not available to small businesses. It is disastrous. There is no reason not to provide more than adequate authority for this program given the fact it's zero subsidy. NADCO requests that you provide an authorization level for 2007 of 8.5 billion to avoid the shutdown in service and accommodate program growth.

The second major issue, as you have heard, is on fees on small businesses that are proposed for 7(a) and 504 programs. NADCO agrees with the committee that these fees should be removed from the budget. It's as detailed in our written statement.

We do not believe we should place additional costs on our small businesses that detract from their ability to grow and create jobs. We are concerned about the precedent of establishing such an administrative fee. How can we be sure that, in fact, these costs are justified or SBA will not continue to increase this fee to cover more of the agency's overheads?

We also are concerned about that this might be the first step in moving SBA's capital programs off budget and out of the purview of Congress. So, in sum, we urge you to make removal of these fees a top priority.

In the last several years, the CDC industry and SBA have gone through unprecedented structural changes. We have seen the cen-

tralization of our loan processing functions. And we have seen considerable expansion of the CDC's area of operations.

These changes are already and are continuing the fundamentally change the nature of the industry and the 504 program. NADCO believes it's critical that Congress take action to firmly establish the purpose and future of the CDC industry and the 504 program.

Aspects of our legislative proposal will help streamline the program, reduce costs to small businesses, and increase their ability to utilize the program, but I really want to focus on one issue. And that is the definition of a certified development company.

CDCs are the most recent embodiment of state and local development corporations that were established over 50 years ago. Our mission and the value that we bring to small businesses, the SBA, and the communities that we serve has not and should not change.

That mission is economic development. As not-for-profit entities, our priority, our passion is to help small businesses grow, to create jobs, to invest, and become owners and to build strong communities in local economies.

We play a role, provide expertise and service to small business and communities and undertake initiatives that banks cannot and should not do. We don't set profitability, return on investment, return to shareholders as our mantras. We count how many businesses we help, how many loans we provide, how many jobs we create, how much private capital we leverage, how many loans we make to women, minorities, veteran, rural, low-income, and what program services and support we provide to meet our economic development mission.

Our boards of directors and our membership are made up of economic development directors for cities, counties, and nonprofits, the Chamber of Commerce, the local CPA, the community banker.

NADCO is deeply concerned that SBA has taken steps to blur the lines between the 7(a) and 504 programs, despite their different missions. And of even greater concern, SBA has introduced competition to the regulatory process that is blurring the lines between CDCs and for profit lenders, deemphasizing our economic development and our accountability and commitment to our communities.

We urge you to take the steps that are outlined in legislation, set the course for the future, and clearly define the purpose and role of the CDC industry as not-for-profit, financial intermediaries that deliver small business programs for the purpose of economic development.

Finally, we ask you to recognize and acknowledge the network of 250 small nonprofit organizations as created over the course of 25 years, tremendously successful and efficient economic development finance program that, in turn, supports a tremendous amount of local economic development programs and services throughout the country.

I would be happy to answer any questions the committee has. Thank you.

[Mr. Chilcott's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you.

Ms. Schubert? I believe also we have a vote in a few minutes, but I think we can hear both of your testimonies and then come back for questions.

STATEMENT OF LYNN M. SCHUBERT, THE SURETY ASSOCIATION OF AMERICA

Ms. SCHUBERT. Thank you, Mr. Chairman. And thank you for inviting us here to testify today on this critical issue.

We are here for one purpose only. And that is to testify about the SBA surety bond guaranty program. You may notice this is the first time you have heard those words, "surety bond guaranty program" since the Chairman's opening remarks. This is not a program well-known outside of the construction community and the insurance community, but it is critical and vital to small businesses, particularly at this time.

The Surety Association was involved many years ago in creating the program. And we remain committed to the viability of the program and the workings of the program.

The existing leadership, new leadership, of the program also appears to be committed. And we look forward to working with them. But they cannot do it alone. They need your help in making this program work.

For those of you who are not completely aware of what this is all about, to obtain a construction project on a public project, whether it's federal, state, or local, a contractor needs to provide a surety bond. Small and emerging contractors have a very difficult time obtaining those bonds until they show that they have a track record of success and they have financial backing.

Obtaining loans for these contractors is a wonderful thing, but it will not get them a surety bond. And they will not get that work without both the loan and the surety bond.

There are contractors who have the opportunity to participate, particularly right now, in the reconstruction in the Gulf Coast states in helping to rebuild those areas as well as rebuild their own businesses. But those contractors are going to need surety bonds.

Surety companies, when the economy is good and everything is strong and contractors are being paid rapidly, sureties are willing to participate with those contractors and put their backing behind the contractor because they believe the contractor will be able to perform the work. If they don't perform the work, the surety then pays the loss.

In slow economic times, however, those contractors have a more difficult time completing the work because pay comes to them slower. Owners are slower in making the payments on the project. It is more difficult for them to complete the work.

Sureties understand that. They have a responsibility to make sound business judgments. They have a responsibility to their shareholders. They cannot take a risk that the contractor is not going to perform when it's not a sound business risk. That is where the bond guaranty program comes in.

What the SBA does is provides guarantees up to 70, 80, or 90 percent of the loss depending on the particular program, for small contractors if a surety will write that bond.

Because the surety writes the bond, the contractor can work on public construction. They can establish a track record. They can become a stronger contractor. They then are moved by those sureties from the bond guaranty program into the standard surety market, meaning that the surety will write that contractor without the

guaranty, allowing, then, more capability or capacity for new and different contractors to come in through the guaranty program.

It's a win-win for everybody who is involved in the program, but the program is in serious trouble. There has been very little commitment to the program over recent years. And there are a few fundamentals that just absolutely have to be changed to make this program work for small contractors.

First, the program has to recognize that as surety companies lose money in certain years, the program is not going to be self-sufficient every year. It will make money some years, and it will lose money some years.

OMB has determined it needs to be self-sufficient and has proposed a 60 percent fee increase to the sureties. This is absolutely untenable. A proposal has been made to reduce the fee increase but to make up the funds to increase the fee to the small contractor. The small contractor is already paying enough to participate in this program. This needs to be changed.

The rates that sureties are allowed to charge in the program are stuck in rates that were established in 1987. Those are 20 years old. If we can just have a change that would allow sureties to charge the rates that are approved by the state insurance departments, then the program would be more financially viable. And there needs to be more funding for staff and for education of the staff on the surety bond program.

As you could probably tell by listening to all of the testimony here today, just like everyone else, the staff at the SBA regional offices know a great deal about the loan programs and very little about the bond program. They need training on the bond program. There needs to be a commitment at the highest level to this program.

Sureties are interested in the program. However, it has to be financially viable for them to participate. We would like to work with the SBA and with Congress to make this a workable program for small businesses in the United States.

Thank you.

[Ms. Schubert's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you very much. I think that we are down to just a few minutes of the close of the vote. So if it all right with you, Ms. Mayo in particular, Mrs. Millender-Mcdonald, I think both of us would like to go. And she would like to be here to hear your testimony.

So if we can postpone you until we get back in about—I think it's one vote. So probably about ten minutes we should be back. Thank you. We will be in recess.

[Brief recess.]

Chairman BRADLEY. Thank you again for your forbearance. At this time I would like to recognize Ms. Mayo. Thank you once again for coming so far.

STATEMENT OF GRACE MAYO, TELESIS COMMUNITY CREDIT UNION

Ms. MAYO. Thank you, Chairman Bradley; Ranking Member Millender-McDonald; and, of course, Ms. Velazquez. On behalf of the Credit Union National Association, which we refer to as

CUNA—and I will do that within my message—I obviously appreciate the opportunity to address the Small Business Administration's funding level and fee structure for the 7(a) guaranteed program.

I am Grace Mayo once again, President and CEO of Telesis Community Credit Union. And my wonderful congressman, Brad Sherman, was delightful to come in and give me that intro. So thank you for seeing him.

Just so you know, I am also the chairperson of a credit union service organization as credit unions are cooperatives. And one of the things that we do best is we share our resources amongst each other. So with that, we created this MBL CUSO, member business service called Business Partners. We are cooperatively owned by 14 credit unions around this country, and we service 160 of them nationwide.

What we do is we try to use our resources in assisting them to provide member services, especially the SBA lending program. So we unite, use these expertise, and get to the membership as soon as we can.

CUNA represents basically 90 percent of our nation's approximately 8,800 state and federally chartered credit unions. With that, we represent over 87 million members. So, once again, we are so thankful to let us be here and share this because we are a growing entity in obviously the entrepreneurship. These are members that have either lost their jobs, have downsized, and now are looking at becoming entrepreneurs.

And within my written testimony, as you will notice, Telesis has been very active. In fact, we are the largest SBA lender in California. And, darn it, we're going to continue that because we have seen the enrichment that this program along with our business lending programs give to the entrepreneurs.

In my written document, you will see that the first two have been females. They are, of course, the ones that we are also trying to make sure that we support accurately. And the movement totally understands that.

The industry has only been given SBA approval since 2003. They issued a legal opinion removing restrictions. And so we're very new to this marketplace. However, we love SBA. And I use that adjective, but we do sincerely mean that.

Without this program, because of our overregulate burdens on the member business side, we have no choice but to make sure that we utilize the wonderful SBA programs. This is good news for credit unions, and obviously it's even better for small businesses as you have documented in your written testimonies.

So we understand the SBA. And we understand it is very difficult from the SBA that some of our small business owners cannot get these loans from the larger banks, especially as the conglomerates take its place.

Credit unions are very well-known to give out smaller business loans. In fact, our average SBA loan limits are somewhere around 98,000 on the average. This is our niche. This is what we want to do. And when we help our members, I'm not kidding you. I would believe if they were here today, they would hug each and every one

of you for getting it because the entrepreneurship is the growth of our economy.

Once again, credit unions are homegrown. We are community credit unions for the most part, regardless of our bonds. And so this is our mission.

CUNA is hopeful that credit union participation in the 7(a) program will continue to grow. Of course, we have concerns, though, with the appropriation. We highly support the appropriation funding, not only for this fiscal year but beyond.

And, of course, we urge you not to support the fee increases because our small business members are the ones that are burdened. And the last thing we want to do, obviously, is to turn them away.

And what has happened is when we have SBA loans that are turned down in our institution, we literally have calls from the outside market, capital venturists, hard money lenders, that say, "If you didn't approve of the SBA loan, can we have that referral?"

Now, that might be a good thing to a certain degree, but the down side is for the long term, that small business owner is giving up sometimes their equity position in the company. And they're obviously not being charged the up-front fees, but their interest rate is severely higher.

So, once again, CUNA strongly supports legislative initiatives to reduce the program's fees, especially when it comes to the smaller loans, and has advocated for the highest possible appropriation.

Additionally, as credit unions and credit union members are—and you have to understand they are accustomed to almost no fees from credit unions. This really takes us out of the marketplace so that we can provide this type of wonderful program's ongoing futures.

Many credit unions, including mine, have been approached, as I said, once again, by outside entities. And we don't want to turn these entrepreneurs down.

Another roadblock—and this is significant for us—is that there is a threatening ability for us to expand in the 7(a) program. As gracious as they were and Hector Barreto was wonderful in aligning our industry to come in and support this program, we are imposed with a very big cap. In fact, this program in member business loans has a cap of 12.25.

CUNA strongly supports H.R. 2317. It is called the Credit Union Regulatory Improvements Act, which proposes, among other things, to increase the current cap that credit unions are limited to in providing business loans at 12.25 to just up to 20 percent. It also increases the loan threshold from 50,000 to 100,000.

Through the government guaranteed portion of the 7(a) program, basically we believe that if you help us raise this cap, we can then continue to support the SBA program. The arbitrary limits that are currently in place greatly restrict many credit unions' ability to offer business loans and, as a result, once again, may prohibit us in providing the 7(a) program to our members.

In reforming credit union member business limits, as proposed in H.R. 2317, Congress will help to ensure a greater number of available sources of credit to small businesses. More credit unions could enter the business lending market and take advantage of the SBA's

7(a) and other loan programs, which ultimately benefits the small business owner.

In closing, we urge Congress and this Subcommittee to reconsider the importance of the 7(a) program in helping support small business in this country and improve the funding process for this very significant program by, one, pursuing legislation that would reduce the program fees without affecting the program level; two, restoring the 80 million appropriation for 2007 and, I urge greatly, in the future; and, of course, three, reforming the credit union members' business lending limits.

I thank you so much for this opportunity.

[Ms. Mayo's testimony may be found in the appendix.]

Chairman BRADLEY. Thank you all very much.

Let me start out the questioning with a question to Mr. Hager. There has been testimony about increasing the cap size of the 7(a) loan to $3 million. What would be your position on that? Would you favor something like that?

Mr. HAGER. The $3 million proposal that we received information on in the last couple of days in 2007 would have a slight positive impact on the subsidy rate.

We have not seen, I have not seen personally a lot of demand for a $3 million loan. We believe what we have is sufficient.

Chairman BRADLEY. So you don't think it is necessary? Okay.

A question to Ms. Mayo. In your testimony, you mentioned that the credit union average loan size is less than $100,000. I think you said 98,000. Yet, 7(a) loans under $150,000 have grown pretty significantly, even after fees were raised. Why do you support the appropriation to eliminate the fees in that case?

Ms. MAYO. Because even though we have all grown—and honestly when you design a program which focuses on the smaller loans and as lenders, that is exactly the marketplace we will go for—what is happening here is that if you start increasing those types of fees, it makes it much more difficult for us to persuade our member borrowers to take this program.

So what we are hoping for is that there will be less of these fees in the future. I mean, if we are going to live with what we do today, I believe we will continue. But if you lessen it, I believe it gives us all more opportunities to go after and help those entrepreneurs that have already been gun-shy.

So for all the increases you see, the other question is, how many have we not helped because of this?

Chairman BRADLEY. Mr. Wilkinson, would you comment on the same question?

Mr. WILKINSON. Could you repeat the question, please?

Chairman BRADLEY. Well, the question is that the loan growth of under $150,000 has been pretty significant, I believe about 25 percent over the last couple of years, despite the increase in the fees.

And I would say, just for full disclosure, I think I have agreed with the minority members on the committee and have opposed, actually, when we have had a chance to vote on this on the floor imposition of the fee.

So I am interested in the fact that, even despite these fees, the loan growth has been pretty significant. Why do you think that is

the case? And is it as major an impediment as some people believe it is, obviously Ms. Mayo?

Mr. WILKINSON. Well, the fees have just been one part of the issue. And yes, there have been some fee increases, but the small loans have taken the smallest portion of the increase. But the other side of that coin is that the indirect costs of this program have actually gone down.

SBA has done a very nice job over the last five years with their SBA Express program. And they have taken other initiatives that have streamlined the process, making the smaller loans much easier today than it was five years ago. So while there have been some fee increases, there have been some indirect cost decreases to offset that. And yes, volume has been up 20-25 percent.

Chairman BRADLEY. And even if the fees are to continue, as the administration's proposal would have it, do you feel that that volume growth is also going to continue as the demand is out there?

Mr. WILKINSON. I don't know that we will continue to see 25 percent growth, but that would be more of a function of the significant rise in interest costs we have seen over the last couple of years, too.

I mean, a couple of years ago, prime was half of what it is today. And higher interest rates slow down demand. And so we are seeing a little softening, but it would be more attributable to higher interest rates.

Chairman BRADLEY. Another question to you, Mr. Wilkinson. The 7(a) loan program has now been without an appropriation and has been self-funded for a fairly long period of time. Are your members happy with this situation?

Mr. WILKINSON. Yes. We went to zero subsidy at the beginning of the last fiscal year. So we have been on zero subsidy now for a year and a half. And we have had plenty of loan authority to meet demand. We have not faced any of the caps, shutdowns, program restrictions that we suffered through the decade previously. So thus far, zero subsidy has worked just fine.

Chairman BRADLEY. Ms. McDonald?

Ms. MILLENDER-MCDONALD. Thank you so much, Mr. Chairman. And thanks to all of you for your testimony.

Mr. Hager, I am deeply concerned about the increase in fees, especially to those who tend to not have the opportunity to get loans in the manner that they solely need. And when you have a community such as mine, which starts at the base of Watts but goes down to Virginia Country Club, then I have from the most impoverished to the most affluent. But I am speaking about those that are the small ones in the Watts and the Compton area.

We know that SBA eliminated the prime and the microloan programs in its budget. Why is it that SBA is opposed to having specific programs targeted to low-income communities?

Mr. HAGER. Thank you for the question. You know, if you take a look at 2005 and 2006, the number of loans at 150 and below, the total loan portfolio of the SBA, 78 percent of those loans were less than 150.

Ms. MILLENDER-MCDONALD. Were less than?

Mr. HAGER. A hundred and fifty thousand. So we are making lots of smaller loans. I mean, our growth in the smaller loans has been outstanding. We believe that a combination of—

Ms. MILLENDER-MCDONALD. To whom are you making those loans? I need to have them more specifically identified. Are they women? Are they minorities? And within the minority, who are they? Are they disabled? I need to have some specifics on that percentage that you're speaking of.

Mr. HAGER. You know, I would be pleased to—

Ms. MILLENDER-MCDONALD. Provide that for me?

Mr. HAGER. Absolutely.

Ms. MILLENDER-MCDONALD. Would you please do that?

Mr. HAGER. The thing I would like to comment on is that in my opening comments, I referenced the number of loans that were being made to women and—

Ms. MILLENDER-MCDONALD. You have. And I have that.

Mr. HAGER. Yes.

Ms. MILLENDER-MCDONALD. You have 23 percent to minorities—

Mr. HAGER. That is correct.

Ms. MILLENDER-MCDONALD. —and 39 percent to women.

Mr. HAGER. That is correct.

Ms. MILLENDER-MCDONALD. But within that scope, I need to know how many within that—the 39 percent are women. How many of the 23 percent to minorities are that of women? You see, because sometimes when you say 39 percent women, 23 minorities, they are still intertwined within those percentages.

Mr. HAGER. That is correct.

Ms. MILLENDER-MCDONALD. So that's why I want to know just where are we in terms of that.

Mr. HAGER. I will get the number for you.

Ms. MILLENDER-MCDONALD. I need to have that, sir.

Mr. HAGER. I want to bring up—I keep hearing the fee issue. And, you know, it was part of the comment here.

Ms. MILLENDER-MCDONALD. Yes.

Mr. HAGER. I want to show, if I may—I've got an exhibit that I would like to show. If you take a look at this chart, this chart represents the fee, 7(a) fees, since the year 2002. And if you take a look at these fees, the only fee that is greater than at any time since 2002 is the half of one basis point we're talking about for next year, for the annual fee. And it's going up to the threshold that we're allocated to. But all other fees are no more than they were back in 2002. We have held those fees.

We believe our fee structure is very solid. We believe it's good when you compare it to what has gone on with rising costs throughout the country in financial services. So we feel pretty good about the fee structure.

Ms. MILLENDER-MCDONALD. Well, is that fee structure anyplace within your group, sir?

Mr. HAGER. No, ma'am, it is not.

Ms. MILLENDER-MCDONALD. The other question that I do have is that your 7(a) program has returned in excess of $1.2 billion in excess of these fees to the treasury in the past 10 years. And it's due to its overcharging of small businesses and lenders in the program.

Now, rather than increasing 7(a) fees, as the administration recently did and proposes to do it again, why didn't the SBA propose a plan to write this wrong and return the money that it wrongfully took from the program participants in the first place?

Mr. HAGER. You're going back in history on me that I—

Ms. MILLENDER-MCDONALD. I understand that. And I'm saying you don't go back that far but as far back as you go. And I would like for you to look into that. I would like for you to look into that because if there is any funding that is being returned back to the treasury from those who have been overexposed by fees, then certainly that should be something that is put back into a pot for these small business people to get.

Mr. HAGER. I will absolutely when I get back look into that.

Ms. MILLENDER-MCDONALD. Okay.

Mr. HAGER. It's a good point.

Ms. MILLENDER-MCDONALD. Mr. Wilkinson?

Mr. WILKINSON. Ma'am?

Ms. MILLENDER-MCDONALD. You said in your presentation—I started writing all these names until I don't know now just what. I might ask you a question that should have been someone else's. But you did speak to administrative fees.

Mr. WILKINSON. Yes, ma'am.

Ms. MILLENDER-MCDONALD. And you don't know whether that's a government function in the first place?

Mr. WILKINSON. It is a government function, the lender oversight part.

Ms. MILLENDER-MCDONALD. But you did have some question about the administration fee imposition?

Mr. WILKINSON. This is a fee that has nothing to do with credit subsidy. It is a fee to start paying salary and expense dollars.

And I still don't understand why the magic number of 7 million. It just appears to be a start of okay. This year is 7 million. Next year is 17 million. At some point in time, they want to have all the administrative costs covered by the program, which, in effect, what a government-sponsored enterprise is. And so if we're going to go down that road, we should just recognize it up front. Let's have that discussion.

Ms. MILLENDER-MCDONALD. And, Mr. Chairman, just, really, one more question, please. And that is I see my red light, but I have got to ask this question.

Now, when you talk about the amount of increase in the 7 loan—I think, Mr. Wilkinson, you proposed that. I was trying to follow you.

Mr. WILKINSON. The increase in the maximum loan size.

Ms. MILLENDER-MCDONALD. Yes. Yes, it is yours.

Mr. WILKINSON. Up from 2 million to 3.

Ms. MILLENDER-MCDONALD. That is correct. And, yet, small businesses don't really partake in that because those small loans still do not go to the smallest entrepreneur. Those loans tend to still go to the highest level of those who are requesting loans and do not go to the lower borrower, which means even if it's an increase, this does not necessarily help that lower entrepreneur, it seems, from the data that I have gotten.

Mr. WILKINSON. Okay. I guess I am not totally following the question.

Ms. MILLENDER-MCDONALD. All right.

Mr. WILKINSON. But we're missing a gap in our program. I disagree with Mr. Hager from SBA that he hasn't seen them in. I just

had our management retreat last week. And the number one topic from the folks who attended was "We need a way to service our clients who need bigger loan requests. And we're missing those loans between 2 and 3 million dollars."

Now, that is a different kind of product than the small loan product that is being done through SBA Express.

Ms. MILLENDER-MCDONALD. And we understand that. But our 7(a) loan programs have also been for the little guy and girl, too, to some degree.

Mr. WILKINSON. Well, I think that is why you see 78 percent of our numbers of loans that are being made are in the small loan category.

Ms. MILLENDER-MCDONALD. All right. Let me just say this. This committee is Tax, Finance and Export. I want to see more small businesses have an opportunity to go international, but how can they when they do not even in their own country have the propensity to get loans and to have those in a credible way where fees are imposed in a way that they cannot broaden their horizon, if you will?

Thank you, Mr. Chairman.

Mr. WILKINSON. If I could just add one quick comment on that? Without the bigger loans, we're going to see pressure in the subsidy rate going forward, which we're going to have to consider raising fees on those small loans in the future. And that's why we need to add the bigger loans that pay higher guaranty fees that subsidize the cost of smaller loans included in our loan mix.

Ms. MILLENDER-MCDONALD. I will come back to this later.

Chairman BRADLEY. Congresswoman Velazquez?

Ms. VELAZQUEZ. I will defer to Ms. Moore and then the—

Chairman BRADLEY. I am sorry. Congresswoman Moore?

Ms. MOORE. Well, thank you, Mr. Chairman. Thank you, Ranking Member, for yielding.

I think I want to start my line of questioning out to Mr. Wilkinson because I was confused or stunned a little bit by a comment you made as I was coming into the room. And perhaps you have answered it already. But you talked about the larger loans subsidizing the smaller loans.

I'm very concerned because there seems to be a huge gap in loans made to minority businesses versus majority businesses. And as those loan volumes decrease, most of them being made under $150,000, the guaranties also decrease, which squeeze minority businesses more and more and more.

I am wondering because it is my sense that there are many small minority businesses that come with the same portfolios, the same capacities to borrow but, yet, they don't get the larger loans and they also don't get the larger guaranties.

And given our discussion here today regarding increasing fees for borrowing and so forth, I want to know how we meet our goals to provide more funds to minority businesses in this environment.

Mr. WILKINSON. Well, first of all, looking at the number and the dollar amount of loans going to minorities back to 2000, we have gone from 26 percent of the numbers of loans up—

Ms. MOORE. How about the amount? I'm talking about the—

Mr. WILKINSON. —to 34 percent. And the dollar amount, we have gone from 30 to—let me get on the right line here—33 percent of the dollars. And that's year to date in 2006.

Ms. MOORE. But you seem in your testimony to be advocating for lower loans, for under $150,000 loans, which also reduces the guaranties.

Mr. WILKINSON. We support making small loans. And you can see that. There has been a tremendous growth in the amount of small loans being made. But those loans pay a disproportionately low guaranty fee.

So as that part of the portfolio becomes bigger and the large loan part becomes less, we collect a smaller guaranty fee. That means the subsidy costs are going to go up. So what we have to do is get some more larger loans into the mix so that the fees on those smaller—

Ms. MOORE. Give the larger loans to minorities is what I want you to do.

Mr. WILKINSON. I would be happy to give it to whoever.

Ms. MOORE. But that is not what is happening from those data.

I want to ask Mr. Hager before my time expires questions about the commitment to venture capital for minorities. The President has—you know, there has been a rescission of the new market venture capital program. For as long as I have been here, last year and this year again, there has been no reauthorization of the new market venture capital program.

I know you are going to tell me about the SBIC and so forth. Those loans are available to more mature companies, the debenture program. Can you tell me how we propose to meet our goals to help minority business, small businesses, women-owned businesses when we are not committing to the generating of these businesses?

We are proposing higher fees. We just heard Mr. Wilkinson talking about—you just heard the dialogue between us regarding minority businesses getting lower and lower and lower loan amounts. And I am concerned that we are not meeting our mission to help grow minority businesses in this environment.

Mr. HAGER. Thank you. Congresswoman Moore, more than 15 percent of SBIC funds licensed between 2002 and 2005 had at least one minority or female fund manager.

Ms. MOORE. Thank God for that one.

Mr. HAGER. I said either one minority or one female that was in a very large position within that SBIC.

I believe that one way to accomplish what you're concerned about is making sure that the infrastructure of the SBIC ownership, if you will, are minority and women. And they will definitely look out for—

Ms. MOORE. But why not just fund the new market venture capital program, which would be a more direct—there would be a more direct match in those types of businesses that could benefit from it, as opposed to those minority businesses that have to reach such a high bar?

The SBIC clearly is targeted for more mature businesses. And we know that minority businesses are last in. So what I am saying is that translation to me is—because we saw what happened with the

first round of the new market venture capital program. There was significantly more minority participation.

And the fact that it has not been reauthorized indicates to us a lack of willingness to generate those businesses. It's a more direct way of doing it. Wouldn't you agree?

Mr. HAGER. I still believe that one way to achieve the concern that you have is to make sure that we have women and minorities in fund manager positions, meaning the very top of the leadership of that SBIC, to enable that SBIC to be looking and targeting more venture capital funds to minorities and women. I believe again that that—

Ms. MOORE. You have completely not answered my question because the fact is that the SBIC loan program structure is inimical to minority businesses that make up 50 percent of the small business community. The new market venture capital program is structured to assist businesses that are minority businesses.

And you have so not answered my question. Thank you.

Chairman BRADLEY. Congresswoman Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Hager, we are working on a reauthorization of SBA. In light of your earlier comments that the larger loan proposal creates a positive subsidy rate for F.Y. 2007, would SBA support putting this proposal in the committee's reauthorization bill?

Mr. HAGER. We support the proposal that is in the budget today. I would not go beyond that.

Ms. VELAZQUEZ. So that means that anything that is not in the proposal, you are opposed to?

Mr. HAGER. I would not go beyond what is in the budget.

Ms. VELAZQUEZ. In your testimony, you mention that the loan monitoring system is able to draw on historical as well as projected performance of SBA loan portfolio.

Mr. HAGER. Right.

Ms. VELAZQUEZ. I am concerned that the recent hurricanes could increase defaults in SBA loan programs and lead to further fee increases in the future. How have the recent major hurricanes affected the SBA's portfolio to date? And what are your expectations of the potential future impact?

Mr. HAGER. Congresswoman, that is an outstanding question and one that as we look upon the Gulf area—I have spent a lot of time down there. I was down there two days last week. I've gone back and forth many times, concerned. What are we going to start seeing in trends?

And I am pleased to say so far we have not seen a degradation of those trends. We will continue to monitor it. We will continue to watch it. We will continue to be flexible wherever we can. But so far we have not seen a degradation of the portfolios down there yet.

Now, again, it's still early. And it takes a lot of constant monitoring to see what kind of trend may develop. But so far it's okay.

Ms. VELAZQUEZ. Ms. Grace Mayo, 85 percent of the 1,759 credit unions that offer business loans do not participate in the 7(a) loan program. And only 93 credit unions have actually made at least one loan in the program. Are the high and constantly increasing

fees associated with the 7(a) program deterring credit unions from participating in the 7(a) program?

Ms. MAYO. To a certain degree, yes. And I do have a suggestion, though. If we do have the larger loans come in, one of my concerns, obviously, as an industry is, is that going to impact all of the 7(a) program, especially if we're talking about the smaller loans?

If anything, maybe as a committee, my suggestion could be—and this is just Grace Mayo alone—that possibly if we have the continuation of the subsidy or the zero subsidy, then maybe we can consider a higher guarantee for the smaller cap, the smaller loans. Maybe then we can have even more momentum to the minority groups and really carve that program out.

But, going back to your question, the other problem with our industry is, one, we're very new to the SBA world because we did not have that authority until 2003.

The other reason is SBA in its own right—and I'm not putting any negative comments, but they have had to downsize their resources. So it takes us a while. The SBA program is not that simple to administer. And we would obviously like to engage. But it is also the MBL cap that we're prohibited to really commit ourselves into these programs.

Ms. VELAZQUEZ. So let me ask you if there is a point at which higher lender fees make this program not worth it for credit unions.

Ms. MAYO. Right. We would see less participation, absolutely.

Ms. VELAZQUEZ. Mr. Wilkinson, in your testimony, you state that "It is significant that the budget clearly shows, as NAGGL has long argued, that the large loans subsidize small loans." Given the significant decline in the average size of the 7(a) loan, is it your opinion that SBA's focus on making smaller loans through SBA has ironically created the dire situation that we now face?

Mr. WILKINSON. Well, they have had a focus on small loans, particularly through the Express product, but I don't think they have tried to exclude large amounts up to the point where they banned us from using combination financings. That provision of law expired, a combination financing or piggyback.

So we don't have a way to get the larger loans into the loan mix. That's where we need that big loan back in the mix to keep the fees down so we don't face fee increases in the 2008 budget.

Ms. VELAZQUEZ. I will come back, Mr. Chairman.

Chairman BRADLEY. As long as everybody is okay, we will have a second round of questions.

Ms. VELAZQUEZ. Sure.

Chairman BRADLEY. Mr. Wilkinson, I would like to go back to the microloan situation. The testimony of the SBA and Mr. Hager is, if I can paraphrase it correctly, that because more and more smaller loans are being made and a greater percentage of smaller loans, that the microloan program is not as necessary as it is in the past. Would you agree with that assessment?

Mr. WILKINSON. First of all, I am not a microloan expert. So I have not ever participated in that program. I have had some discussions with some folks who have done microloans. And it is my understanding from them that their average credit scores are quite

a bit lower than the average credit scores that we would use in a 7(a) product. But that's the only information I would have.

Chairman BRADLEY. Anybody else want to chime in on that?

Mr. CHILCOTT. Sure, Mr. Chairman. CDC small business finance is an SBA micro lender. We also offer a number of other products for small businesses that would not otherwise be available as a part of our mission. And, in essence, what we are able to provide is if a small business contacts us, we provide access to a full range of alternative finance programs for that small business.

It could be a 7(a) loan. It could be a 7(a) community express loan. It could be our SBA microloan. It could be a loan pool that we have that a number of banks have created. So in the full range of financing that is available out there, certainly the SBA microloans that we are making are for those who cannot access a traditional 7(a) community express type of loan.

Chairman BRADLEY. So you would support retaining the microloan?

Mr. CHILCOTT. We believe it still serves a viable purpose out there in terms of meeting a need that is not met by other programs.

Chairman BRADLEY. I would like to go to Ms. Schubert for a moment. There has been so much talk about the Gulf Coast. And you focused a little bit on that in your testimony.

First of all, I think you said that there was a necessity for further training for the bond guaranty staff. Would you talk about that briefly?

Ms. SCHUBERT. Yes. Under the Plan A, the regional staff actually approves a bond before it's written. And so for a surety to submit applications to regional staff to ask for approval of a bond, you need someone at the staff level who actually knows something about underwriting surety bonds.

Unfortunately, there have been over the years changes in the staff, reductions in the staff. And there are not as many well-trained surety folks out there.

Chairman BRADLEY. And is this essential in getting reputable contractors into the Gulf Coast area and ability to rebuild?

Ms. SCHUBERT. We believe it is. If you want to allow the local and the small businesses to participate in that rebuilding, they're going to need bonding capability, particularly with some of those businesses having had the same kinds of issues as other businesses in the Gulf Coast. They have lost some of their capacity. They have lost some of their people, some of their construction equipment.

We are going to need a guaranty to back up the sureties' willingness to take that risk to assist those contractors to participate in those programs.

Chairman BRADLEY. Let me move in the time remaining in this round of questions to Mr. Mercer. Sir, what happens if there's no legislation that restarts the participating securities program or a similar equity-focused program?

Mr. MERCER. Well, equity financing, as the Chairman knows, is how you start small businesses. I mean, you can't have debt without equity. So all the SBA lending programs to any small businesses depend on those small businesses having a strip of equity, sufficient equity, to qualify them for loans.

The participating security program is the only pure equity program in the SBA arsenal. So a company like Build-A-Bear, for instance, which I think maybe you know of or anybody who has children knows of, was launched by two SBICs, now a very successful public company. That's not the type of program that traditional venture capitalists, who focus on high tech investments and biotech, are going to invest in.

Over the past four or five years, about $4 billion of investments have gone into manufacturing companies, 30 percent of the investments last year. That disappears. So small companies—and they are few in number, but they tend to be the gazelles that grow dramatically and then will need senior lines of credit—will not have equity available to them.

Chairman BRADLEY. Mr. Hager, do you want to chime in on any of those questions?

Mr. HAGER. The only thing I would say, Chairman Bradley, is that the participating program is going to cost the taxpayers $2.4 billion. We have another 3.6 billion promised. That's going to yield another 500 million to 700 million. We don't know what that number is yet.

The program is a bad deal for the taxpayer. The program, I think the venture capital monies that we believe can more effectively be used will be the debenture program. We have absolutely no problem with that.

We do have a problem with funding a program that is costing the taxpayers unbelievable amounts of money of their dollars.

Mr. MERCER. Could I?

Chairman BRADLEY. Sure

Mr. MERCER. One, SBA is in a negative cash position. That's correct. We won't know for 12 or 13 years what the eventual outcome will be in terms of absolute loss. Right now it's in a negative cash position.

The economy has improved. SBA receipts from the participating security program are increasing dramatically. So maybe in 12 years, we can come back here and figure out what the actual loss is going to be.

There's no question and the industry has agreed that there should be some restructuring of the economics, if you will, in quotation marks of the participating security program to address the risk that SBA has.

And a substantial amount of that $2 billion in negative cash is the result of the crash of the economy that we just went through in the recession. I don't think anybody's portfolio remained unscathed. And participating security SBICs during that period did not perform any worse than the funds that, for instance, CalPERS invested in.

So to say it was a fatally flawed program is just not true. Does it need adjustment? Can it be restarted? Yes. It really depends on whether Congress wants to have an equity program.

Thank you.

Chairman BRADLEY. Congresswoman McDonald?

Ms. MILLENDER-MCDONALD. Yes. Thank you so much.

Mr.—is it Chilcott?

Mr. CHILCOTT. Chilcott.

Ms. MILLENDER-MCDONALD. Why is it that the 504 programs are not as well-known as the 7(a) programs? And has the reduction of the SBA fill staff affected the 504 programs' liquidation?

Mr. CHILCOTT. I would be happy to answer that second question first if that's okay.

Ms. MILLENDER-MCDONALD. Whatever.

Mr. CHILCOTT. I will get to the first one. But certainly with regards to what is happening with SBA 504 liquidations, we have a major concern, which we have expressed for some time now, that as the District's portfolio management staff has been eliminated, that, in fact, a number of our loans that are supposed to be handled by SBA are not being liquidated in an effective and timely manner.

And there are many CDCs across the country that do not have information about what is happening with their loans. We're not sure about the status of that. We know that they are there, but we have been unable I think to really get the kind of information that would provide any sense of recoveries, what's happening with those loans. And if I'm a small CDC and I've got a couple of loans in liquidation and they are not liquidated in a timely manner and I suffer losses, that has a big impact on my ability to deliver loans and on SBA's oversight of my organization.

So we continue to be concerned about those loans that have been stuck between eliminating the portfolio management staff and our hope and legislation that will hopefully move that responsibility with compensation to the CDCs themselves.

In terms of why the 504 program is not well-known, I think my first response to that is that in many ways it depends on the area of the country that you're in in terms of how well-known the program is.

I would say in California, we have—that program is very well-known. We probably have more banks that are helping to offer and market that program. We have an extremely strong secondary market that is buying the first trust deeds. And the program is just very well-known out there in the marketplace.

Ms. MILLENDER-MCDONALD. And I know you support the 504 programs. I am just saying that you might think in California, perhaps in some areas, there is a great appreciation for the program, but there are some areas that still do not.

And, Mr. Hager, I come back to you on that because we know that 504 lending is expected to increase by at least 20 percent this year. So how many employees does SBA intend to add on to the centers to process this increased loan volume, especially in minority communities?

Mr. HAGER. An excellent question. We have a strategy that has been created to handle the loan volume. I mentioned it in my opening comments.

Ms. MILLENDER-MCDONALD. Yes, you did.

Mr. HAGER. We are going to manage the growth. And the way we manage the growth is to make sure that we have a proper infrastructure to handle the increased loan volume.

The SBA has a number of proposals that are very close to closure, centralized loan processing. And in 504 liquidation, as a matter of fact, we will hopefully very soon move from a lot of the field

staff into two processing centers to be able to leverage our resources to handle and accommodate the loan volume.

We believe that longer-term we have a proposal also on the table to require liquidation from the CDCs and the 7(a) lenders before we actually provide the guaranty. They know more about the liquidation than we do.

So our proposal is let the liquidation take place in the CDCs. We'll manage the growth.

Ms. MILLENDER-MCDONALD. Providing you have the staffing.

Mr. HAGER. Well, the CDC would provide that staffing.

Ms. MILLENDER-MCDONALD. Staffing. Okay. Mr. Wilkinson, do you want to comment on that?

Mr. WILKINSON. Could I comment on that? Yes. The comment period on SBA's proposal to liquidate first, as we call it—they call it the business loan and development company loans, liquidation, and litigation procedures—had some proposals that would be very detrimental to the 8(a) program.

We have sent in a comment letter. And I would like to provide a copy of that letter to the committee and ask that it be included for the record.

Mr. WILKINSON. We are happy to work with SBA. And we have passed this on to them. Our members are happy to do the work of the liquidation process. But honoring the guaranty in a timely fashion is going to be very important.

Delaying any kind of payment of that guaranty to the end of a liquidation, which can sometimes take 18 months to 2 years, becomes very expensive. Those costs are going to turn right around and be put back on—

Ms. MILLENDER-MCDONALD. So, Mr. Hager, then how do we honor this in a timely manner, then, to circumvent any imposition of negatives?

Mr. HAGER. We believe, again, that the overall process of transferring the actual liquidation to the lender will enable, actually, a more effective processing of that claim, that, in fact, that at the end of the day won't create delay problems. It won't worsen the purchase of the guaranty or delay it more than what we have today. That's our opinion.

Ms. MILLENDER-MCDONALD. Ms. Mayo, do you want to patch in here?

Ms. MAYO. I just want to support the 504 program in California. In fact, we just did a drug rehab right outside of your area, in Crenshaw, and it was through the—

Ms. MILLENDER-MCDONALD. Not in my area.

Ms. MAYO. No, it wasn't yours.

Ms. MILLENDER-MCDONALD. I'm further south.

Ms. MAYO. It was Maxine's, actually.

Ms. MILLENDER-MCDONALD. That's right.

Ms. MAYO. And she was very happy to—

Ms. MILLENDER-MCDONALD. Don't get us mixed up here.

Ms. MAYO. I won't, but I just want to reiterate that the 504 program is very valuable in helping this type of insurgence, really, to the communities. One area—

Ms. MILLENDER-MCDONALD. We want to see more in my district, though.

Ms. MAYO. I would be happy to as long as you open up our field of membership, but that is a whole different story.

Ms. MILLENDER-MCDONALD. Mr. Hager is going to help us to do that, I'm sure.

Ms. MAYO. He is absolutely right. And the only thing that we do ask is when we go and, unfortunately, if the business does go in failure, then obviously the guaranty portion needs to be expedited very quickly back to us as a lender.

So we're happy to take that initiative. I believe that is our role. I think that helps expediently get through the process of losses. But then the response back from the agency needs to be just as efficient.

Ms. MILLENDER-MCDONALD. I just want to again make a statement that our communities need these programs. And they have got to be broadened where they get to the very little Joes and Janes in the communities. And that is what I am talking about.

Thank you so much.

Chairman BRADLEY. Congresswoman Moore?

Ms. MOORE. Well, thank you, Mr. Chair.

I believe it was Mr. Mercer who really gave us the discourse on how the SBA loan programs were in a negative cash position and that was one of the bigger problems. I guess that leads me to sort of take another stab, Mr. Hager, at my question that I had for you.

I am wondering, I am suspicious, quite frankly, that programs that benefit minority communities and minority entrepreneurs, women entrepreneurs, that the SBA is balancing its act on their backs.

We look at the 7(a) program. I mean, it's a program designed for those people who are unable to get financing on reasonable terms. The new market venture capital program that we talked about before, it focused on investments in low-income communities. The community express program again focused on under-served communities, with 85 percent loan guaranty.

It seems to me that given the strapped position of SBA, that they're targeting the programs where program guidelines would more benefit minority lenders. And I'm wondering why the administration is—it appears that they are balancing their acts on the backs of minorities. I guess I want you to respond to that.

Mr. HAGER. Congresswoman Moore, in all due respect, I totally disagree that we are balancing anything on the backs of minorities and—

Ms. MOORE. These are the programs that are not getting refunded. The funds have been in rescissions, the programs, the very programs, that would help them the most.

Mr. HAGER. We spend and we have a budget in the SBA of $100 million to assist those that need education on how to apply for a loan. They need education on how to create a business model. They need education on "Well, what do I do with it now? How can I take it on to reality? We have an extremely strong, $100 million outreach program to handle these kinds of issues." Yes, the community express program has historically made loans to a very large degree to women and minorities.

Ms. MOORE. But that's what I'm saying. It expires May 31st.

Mr. HAGER. The pilot for the community express program was extended to May. And there are lots of alternatives being worked out in the community express program.

Ms. MOORE. But I heard just from the ranking member here and others that microloans—how much are you allocating to them, new markets programs?

Mr. HAGER. The microloan program is a program that has been flat. If you take a look at—

Ms. MOORE. Flat? Is that the same as zero?

Mr. HAGER. No, in growth. Microloan has been flat in growth over the last several years. We believe that those loans that historically perhaps the bank walked away from today they're not walking away from those loans. They're making them.

Our loans less than $150,000 amount to 78 percent of our portfolio. I mean, we are making small loans. We are reaching out to communities with $100 million investment in education.

Ms. MOORE. We appreciate the two percent of the venture capital financing that you're giving to minority businesses. We appreciate that two percent. But, you know, just because I'm paranoid don't mean it ain't happening that you're destroying the infrastructure for minority businesses.

And it seems obvious, you know, because, you know, budgets aren't just about dollars and cents. And you have failed to tell me how much money you have put into these programs. They are about priorities. They're about what your values are.

So you can tell us all day long that you want to help, you want to get information out to minority businesses about how to be a business, but when you don't give up the money and when there are recisions on program funds and you flat-fund the programs, you know, like Peter Drucker said, communication is about what ain't being said and in this case about what ain't being done.

My time has expired.

Chairman BRADLEY. Thank you.

Congresswoman Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Hager, recently the SBA IG team concluded a report about the STAR loan program. While I know that you were not at the SBA at the time, what is your perspective on their report? Did SBA implement the program in a manner that was unclear or did lenders simply hear what they wanted to hear?

Mr. HAGER. Congresswoman, that's, again, an excellent question. The STAR program was done before I arrived. I've done a lot of work on the STAR program.

One, the IG audit was at the request of the administrator. He asked for it. Two, the disaster that we all remember on that morning on 9/11 will be with us for the rest of our lives. The need to get money, capital into the affected areas was extremely—

Ms. VELAZQUEZ. Sir, you know, I have five minutes.

Mr. HAGER. Okay.

Ms. VELAZQUEZ. I just can't go into the whole background and history.

Mr. HAGER. You know, very quickly—

Ms. VELAZQUEZ. Will you please answer my question? Was it SBA or the lenders—

Mr. HAGER. It was—

Ms. VELAZQUEZ. —based on the report and the conclusion of the report?

Mr. HAGER. The report concluded that in some cases, documentation was not adequate. We do not believe there is a problem. We think that the lenders that made these loans made them with good faith. And we have a robust process now in—

Ms. VELAZQUEZ. No. I'm not talking about now. I'm talking—

Mr. HAGER. No. I think the program—

Ms. VELAZQUEZ. —at the time when the report was made.

Mr. HAGER. The program served its purpose. It served it in my opinion well.

Ms. VELAZQUEZ. So SBA did everything fine and the lenders did not?

Mr. HAGER. SBA did, we believe, everything fine. The lenders in some cases have not documented. They reached a conclusion without support documentation in some cases.

Ms. VELAZQUEZ. Okay. Let me ask you this. SBA has announced that it will not process repurchases of STAR loans that do not possess suitable lender documentation justifying the loans as a STAR loan. Have you exercised this policy to block the SBA repurchase of a defaulted 7(a) loan?

Mr. HAGER. We are today making sure that there will be no guaranty completed without the proper documentation. In those cases where documentation is not appropriate they are being returned to the lender to make sure that the documentation is there.

Ms. VELAZQUEZ. Mr. Wilkinson?

Mr. WILKINSON. I would agree with Mr. Hager that the STAR program served its purpose. There has been a very limited number of instances where—

Ms. VELAZQUEZ. I just want for you to tell me if you have any concern about the new policy.

Mr. WILKINSON. No, ma'am. The situation seemed to be where there are files with no documentation whatsoever. If the lender did not do that, they need to go put it in the file.

But thus far, the good news is that star loans perform better than the other 7(a) loans made during the same time period. And the issues coming to me regarding STAR loan defaults have been zero.

Ms. VELAZQUEZ. Do you believe, Mr. Hager, that the negative publicity surrounding STAR contributed to the failure of the Go Loan program?

Mr. HAGER. No, ma'am, not at all. By the way, STAR was implemented according to the direction of Congress. The Go Loan program, by the way, is not creating hundreds of millions of dollars, but Go Loan is serving a good purpose.

I talked to Guy Williams, Gulf Coast Bank in New Orleans. And he will—

Ms. VELAZQUEZ. Mr. Wilkinson, the Go Loan program has no—

Mr. WILKINSON. I would respectfully disagree. I had members who said they would not participate in the Go Loan based on the way the STAR issue was blown totally out of proportion. The rider on STAR confused STAR loans with disaster loans. And the mess went from there.

Ms. VELAZQUEZ. Thank you.

Mr. Hager, the significant backlogs related to the recent hurricanes have created substantial processing backlogs for disaster loans. Has the SBA been using District employees assigned to other SBA programs to help with the processing of those loan applications?

Mr. HAGER. Yes, ma'am, they have.

Ms. VELAZQUEZ. How is this affecting these other programs?

Mr. HAGER. It is not affecting those programs. We have loaned in some cases on a very limited basis, and then we transferred those folks back.

Ms. VELAZQUEZ. Mr. Chilcott?

Mr. CHILCOTT. Certainly the use of some of our centralized processing staff in Sacramento for disaster loan purposes slowed down our approval processes. But I would add that those five people are back in the processing center. And we have seen that processing time get down to certainly a reasonable, quick turnaround.

Ms. VELAZQUEZ. Mr. Chilcott?

Chairman BRADLEY. One more?

Ms. VELAZQUEZ. May I?

Chairman BRADLEY. Yes.

Ms. VELAZQUEZ. Okay. Well, let me ask this one. Mr. Hager, looking forward, you have indicated that the agency is not ready to support larger loans to make up a possible funding shortfall in the 7(a) program. You opposed those in appropriation.

What would be our option? Would the agency propose more fees to make a future shortfall in the 7(a) program?

Mr. HAGER. We have everything on the able that we think is required right now. We are not proposing any more fees other—

Ms. VELAZQUEZ. If there is a shortfall, can we get a guarantee that you will not come to us for an increase in fees?

Mr. HAGER. No, ma'am.

Ms. VELAZQUEZ. "No, ma'am" why?

Mr. HAGER. I will not give you a guarantee we won't be back.

Ms. VELAZQUEZ. So what you are telling me is that higher fees are a possibility?

Mr. HAGER. I'm not saying. I will have to wait and see the facts. I can't give you that answer right now.

Ms. VELAZQUEZ. Tony?

Mr. WILKINSON. We are concerned that SBA has used all of the tricks in the bag to get us to zero subsidy this year. We are concerned that if the trend with the declining average guaranty fee continues, that there is not going to be a choice but to push for higher fees. That is why we are pushing so hard on the $3 million loan size to try to keep that average guaranty fee from declining any further.

Ms. VELAZQUEZ. But when we were discussing loan size and all of that, they say, Mr. Hager, it seems to me that he is saying, that higher fees are not an option. So between higher fees and appropriation, what would be your position?

Mr. WILKINSON. Well, our position is the bigger loan size because we think it is subsidy rate—

Ms. VELAZQUEZ. He said, he is on record, that they do not support the loan size.

Mr. WILKINSON. I did not hear him say he didn't support. I heard him say that—

Chairman BRADLEY. I think what he said is that it was not necessary at this time. Isn't that correct, Mr. Hager?

Mr. HAGER. That is correct.

Mr. WILKINSON. I think what he is talking about is the '07 budget. There is nothing needed for the '07 budget. our concern is the '08 budget because we have driven this car to the end of the road.

If I could, I hate to go back to the liquidate first. There are some fee increases in the '07 budget. The lender fee goes up a little bit. That pales in comparison to what the cost of the liquidate first policy can be. And I am really hopeful that we can spend some time on this.

There are two pieces. Who does the liquidation work? Lenders are happy to do that. We originate the loan. We service the loan. We will be happy to liquidate it. But when do we honor the guaranty? Judicial disclosure states it could take up to two years for a foreclosure to be completed with the lender sitting there holding an asset on non-accrual. And it would. It would disproportionately hurt smaller banks.

We're very concerned on the liquidate first policy. That's more expensive than the fee increase we're seeing in the '07 budget.

Ms. VELAZQUEZ. I am telling you we have two options. On larger loans, it is not going to happen. So it's either increasing the fees or appropriation. Where do you stand?

Mr. WILKINSON. I don't know what the fee would be in the 2008 budget. And there may not be one. Performance of the portfolio may be good enough that that is not anything we would have to address. We are just concerned that that is where we are headed.

Chairman BRADLEY. And on that note, if there are further questions for any of the witnesses, they can be submitted for the record. I thank the members for participating in the hearing and thank the—

Ms. VELAZQUEZ. Mr. Chairman, I just would like—

Chairman BRADLEY. —witnesses very much, too.

Ms. VELAZQUEZ. —to make it clear that I will be submitting some written questions to SBA.

Mr. HAGER. Thank you very much.

Ms. VELAZQUEZ. And I expect answers as soon as possible,—

Mr. HAGER. You will get them.

Ms. VELAZQUEZ. —not three months from now.

Mr. HAGER. No. You will get them right away. Thank you.

Chairman BRADLEY. And once again I thank all of the witnesses for participating in this hearing today.

[Whereupon, at 12:41 p.m., the foregoing matter was concluded.]

Good Morning. I welcome you all to a Hearing of the Tax, Finance & Export Subcommittee of the House Committee on Small Business. I am pleased to be working closely with my colleagues as we review the current state of the Finance programs of the Small Business Administration and I look forward to hearing the recommendations made by our witnesses in this regard. That said I would like to thank our distinguished witnesses for taking the time to appear before us today.

Access to capital is a vital element in the success of any venture and the knowledge of where to find such resources is equally essential. Accordingly, one of the key roles of the Small Business Administration is to provide financial assistance to American small businesses.

Small businesses are responsible for more than half of the United States' Gross Domestic Product and the finance programs available at the Small Business Administration are vital to the development and expansion of those small businesses. SBA financial assistance is delivered through investment programs, loan programs and bonding for contractors, among other approaches. It is through these programs that small businesses are able to obtain the means to grow, create more jobs, increase revenue, and help to strengthen our economy.

Over the years, the SBA and its methods of assistance in the strengthening of the small business sector of our economy have undergone some changes and improvements. Today we have the opportunity to hear the comments and recommendations of those who are the frontline of these programs, in order to better understand the demands of the small business sector and to continue our support in the most efficient and economical manner possible. The President's Budget for Fiscal Year 2007 funds small business lending at $28 billion. $17.5 billion of that funding would go to guaranteed loan volume under the 7(a) Loan program. The Section 504 loan program, which provides guaranteed loans for fixed assets such as land, equipment, and buildings, would receive $7.5 billion and guaranteed long-term loans for venture capital investments in small businesses as a supplement to the capital of Small Business Investment Companies would be allocated $3 billion

Congress must continue to enable small businesses to access the capital needed to expand and prosper. The input of those working closely with these small businesses is vital to this Committee as it moves forward with SBA Reauthorization, and with your testimony today we can help create an environment that fosters the growth and development of American small businesses.

I am looking forward to hearing the testimony from our witnesses here today and I look forward to their thoughts on this extremely important topic. However, before we do so, I'd like to recognize our ranking member for her opening statement. Mrs. Velazquez.

DRAFT STATEMENT
of the
Honorable Juanita Millender-McDonald, Ranking Member
Subcommittee on Tax, Finance and Exports
Hearing on "SBA's Finance Programs"
House Committee on Small Business
March 9, 2006

Thank you, Mr. Chairman. I am pleased to join with Members of the Committee today as we discuss an issue of great importance to our nation's entrepreneurs – access to capital.

In today's economy, securing affordable capital is one of the most important ingredients in growing a successful small business.
Access to capital provides our nation's small businesses a strong foundation, allowing business owners to successfully start and expand their enterprises, hire more employees, and purchase new equipment.

Yet many small business owners have difficulty qualifying for traditional bank loans. All too often they are forced to use various methods of financing – such as credit cards and personal loans – to fund their business ventures. Because small business owners cannot access capital in the same way that large businesses can, many need special financing options geared to meet their specific needs.

This is why the SBA's financing programs are so critical to meeting the needs of our nation's entrepreneurs. These initiatives
– including the 7(a), 504, New Markets Venture Capital (NMVC) and SBIC programs fill an important role. Often times, these initiatives fill a financing gap for small firms by making loans on great ideas that probably would not have been looked at twice. By bridging gaps in the capital markets, these programs have more than proven their effectiveness over the years.

In fact, since 1953 nearly 20 million small businesses have received direct or indirect help from one or another of those SBA programs. In turn, the agency's programs have become the government's most cost-effective instrument for economic development – creating jobs and providing stability during times of uncertainty.

However, women, minorities and individuals in low-income communities often face additional barriers in accessing capital. In order for these entrepreneurs to turn their local economies around, they must be given the tools to do so. This is where special initiatives such as SBA's Microloan program come in. This initiative greatly assists minority and women small business owners in their communities. Last year alone, the program provided entrepreneurs with $20 million in loans, and helping many to progress from poverty to successful business ownership.

Clearly, access to capital is access to opportunity for our nation's entrepreneurs. If we truly want our nation's entrepreneurs to have the ability to secure capital, spur economic

development, and create job opportunities, then we must continue to support these programs.

By investing in these entrepreneurs we make it possible for dreams of entrepreneurial success to become reality. This is why it is so important that we are taking the time today to review the success of SBA's financing programs.

Today, we will hear testimony from a variety of organizations and individuals representing the various small business programs.
Drawing upon their experiences in helping our nation's entrepreneurs succeed, I am hopeful that through their useful insight and recommendations we may continue to improve the SBA programs and ensure the success of our nation's small businesses.
It is clear that our nation's entrepreneurs have done an outstanding job of creating jobs and spurring economic growth. In order to continue doing so, they must be empowered with all of the necessary tools – most importantly, affordable and available capital. If we want our entrepreneurs to continue serving as
America's main economic drivers and job creators, it is integral that we lend our support for these vital initiatives.

Thank you, Mr. Chairman.

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
Tax, Finance and Exports Subcommittee Hearing
Thursday, March 9th, 2006

Thank you Mr. Chairman. I would also like to thank Congresswoman Millender-Mc Donald for letting me sit in on this hearing. I appreciate all of the hard work you are doing on this issue.

The President never misses an opportunity to proclaim that small businesses are a priority for this administration – yet time and time again his policies simply do not back up this rhetoric. No place is this more apparent than in how SBA's access to capital programs are being run. Ensuring loans are affordable and that relief from rising capital costs is available are both critical in helping entrepreneurs to remain a driving force in today's economy. While this administration has talked the talk – they have failed to walk the walk.

For evidence of this one only needs to look at the 7 (a) program - the largest long term lending initiative for small businesses. Under the current administration, lending has grown much more costly and harder to obtain. In the past two years alone, costs on borrowers have doubled and lender costs have risen by 118 percent – making it increasingly difficult for small businesses to receive the capital they need.

As if that was not bad enough, in the FY2007 budget, the administration plans to further increase the costs of this program by proposing to raise current fees, and creating a whole new set of fees. This will make the program even more costly – only pushing 7(a) and other lending programs further out of reach. It has become very clear what type of effect these poor policy choices are now having – lending was down by $300 million last quarter. When you factor these new costs, coupled with the rising interest rates, it is apparent that the trend of less and less capital going into the economy is only going to continue.

Traditional capital is not the only place this administration is failing our nation's entrepreneurs. For the last year and half SBIC's participating security program has been shutdown due to mismanagement and poor policy decisions. However, the agency has yet to propose a plan to reopen the program.

I think this speaks to the level of commitment that exists for this nation's small businesses. When you consider this decision in light of the fact that currently less than 1 percent of venture capital goes to minority businesses – it really makes you wonder where the administration's priorities are.

Compounding this is the proposal to abolish one of the most significant policies affecting low income entrepreneurs, the Microloan Program. It is just like this administration to put politics in front of good policy. They continue to call for an elimination of the Microloan program when they do not have the support of one single member of the House or Senate.

This program makes loans to entrepreneurs that are unable to get a traditional loan due to inexperience with credit, lack of assets, or the need for on-going technical assistance. Clearly, this initiative is crucial for the thousands of entrepreneurs that have no other means of financing available to them.

By terminating the Microloan program and not reopening the participating securities program, the administration is turning its back on start ups of all types that need access to seed capital. Blocking access to start-up financing impedes the formation of new businesses and prevents the job growth that is still needed in so many parts of the country.

Small businesses are the major driver of this economy. While it is crucial that we work together to make sure they have the tools needed to thrive and be successful, I don't see the administration coming to the table with the interests of small businesses in mind. This agency's proposals repeatedly represent OMB's interests and not those of our nation's entrepreneurs. Small businesses deserve better than this.

Testimony of Michael W. Hager
presented to the
House Subcommittee on Tax, Finance and Exports
Thursday, March 9, 2006

Thank you Chairman Bradley, Ranking Member Millender-McDonald, and members of the Committee for inviting me to testify about SBA's reauthorization and the FY 2007 budget for Capital Access programs.

I am Mike Hager, the new Associate Deputy Administrator for Capital Access. I manage the guaranteed business loan programs, the investment programs, the surety bond program, international trade programs, and the lender oversight function at the SBA. I am proud to state that the Capital Access budget, like the overall SBA budget, is a part of the President's priority of establishing fiscal restraint and focusing on program results. Each year we are reaching more small businesses at an extraordinary rate and doing so with no lending subsidy for our primary business loan programs.

We have significantly increased our loan volume since 2001, more than doubling the number of 7(a) and 504 loans funded. Each year we are reaching more small businesses at an extraordinary rate and doing so at no subsidy cost to the taxpayer. In FY2001, the loan programs served about 42,000 small business borrowers. In FY2005, this number jumped to 98,000 small business borrowers in the 7(a) and 504 loan programs. We are very proud of the efforts of our staff and our participating lenders to improve service to the small business community. We have accomplished this incredible growth by creating more efficient and streamlined services to the lending community. In response to this growth, we continually strive to improve processes to build a strong infrastructure and risk management.

The President's FY 2007 proposal provides $28 billion in SBA financing for small businesses. The proposal requests authorizations of $17.5 billion for the 7(a) program, $7.5 billion for the 504 program and $3.0 billion for the SBIC debenture program.

The 7(a), 504 and SBIC program levels build on the continuing success SBA has achieved in its loan programs over the past four years. In 2005, we served more small businesses than ever before. In our two major loan programs, we increased the numbers of loans funded by 22% in one year, from 80,000 in FY 2004 to nearly 98, 000 loans in FY 2005. Lending to minorities increased by 23% and to women-owned businesses by 39% in terms of the number of loans funded during the same period. These record level lending numbers are possible because of the zero subsidy policy that was adopted at the beginning of 2005.

As previously mentioned, our main financial programs operate at zero subsidy. Moving to zero subsidy allowed the Agency to continue to meet the financing demands of small businesses without the need for taxpayer subsidy. For the first time in several years, the SBA was able to stabilize the 7(a) loan program and provide financing without the need for loan caps or temporary suspensions of program availability. With zero subsidy, adequate loan levels are established to meet the demands of the lending and small business communities. In addition, it focuses agency resources on enhanced oversight of the portfolio in order to maintain a zero subsidy rate.

To maintain the zero subsidy cost for these programs, minor fee changes will need to occur. To maintain a zero subsidy rate for the 7(a) program, the guaranty fee will nominally increase in FY 2007 from 54.5 basis points to 55 basis points (the statutory

limit). We are especially pleased that the performance of the 504 program permits SBA to lower the ongoing fee from 19.8 basis points to 1.8 basis points for FY 07. We believe this excellent portfolio performance is due to changes in the program allowing for more diversification, enhanced lender oversight and the improved economy. The current unemployment rate of 4.7% is the lowest since July 2001, more than 4.7 million new jobs have been created since August 2003, and 2005 was the fourth consecutive year of expansion for the U.S. economy.

SBA is seeking authority to cover more of its expenses through fee authority that will enhance the ability of SBA to properly manage our programs. The first is a proposed authority to charge a fee, which would apply to pools of Section 7(a) loans sold in the secondary market. We are not proposing a fee at this time, but believe that the statutory authority to charge a fee in the future under certain circumstances, such as interest rate changes that affect the program, is appropriate. Secondly, we are requesting authority to charge fees to Certified Development Companies in the 504 loan program to cover the costs of oversight. We have this authority for the 7(a) program and are requesting comparable authority for the 504 loan program. Finally, we are proposing the addition of an administrative fee to cover the cost of making loans of more than $1.0 million in the 7(a), 504, and SBIC programs.

If necessary, the authority to charge fees on the secondary market loan pooling program would allow the program to continue at zero subsidy. Without fee authority, if the subsidy calculation showed that there was a cost to the taxpayers SBA would be forced to suspend the loan pooling program until authority was given to SBA to collect fees. We do not anticipate charging any new loan pooling fees in FY 2007, but are

requesting the authority to do so in the event it is needed in the future. The secondary market program is a critical component in providing liquidity to the small business market. In most years, 40% to 50% of the 7 (a) loans made are sold into the secondary market.

The proposed administrative fee to cover the cost of making loans of more than $1.0 million in the 7(a), 504, and SBIC programs is separate from the subsidy rate, which exclusively considers the credit risk and potential losses of the loan guarantee programs. The administrative and overhead costs necessary to make loans are excluded from the subsidy rate. Based on SBA's FY 2005 experience, only 3% of the 7(a) borrowers would be affected by this fee. Only 15% percent of 504 borrowers would be charged this administrative fee.

Managing agency resources devoted to SBA's lending activity is another key priority. Many improvements have been made over the past several years by centralizing lending functions. We have centralized 7(a) loan guaranty purchase and liquidation functions as well as 504 loan processing. We are moving toward centralization of the 504 liquidation and purchase components and the remaining about 15% of 7(a) loan processing that is not already centralized. Centralization allows for more consistent application of SBA's policies and procedures. It also allows the Agency to better monitor and manage its performance metrics. The result of these improvements has allowed us to continue to do more with less. We now process 504 loans in two to three days as opposed to previous timeframes of up to six weeks. We now also process guaranty purchase requests in record time. In order to, streamline the process of

becoming a Preferred Lender, we are looking at introducing national status for our PLP lenders, moving from a district by district approach.

We constantly look for ways to improve our lending functions and better manage operations. A major initiative we have underway is to streamline the liquidation process. The comment period for the proposed changes to the liquidation regulations recently closed. The proposed changes would give the Agency more flexibility in managing its portfolio of loans being liquidated. If finalized, these regulations would give SBA more flexibility to sell purchased guaranteed loans using asset sales. We are also proposing that lenders fully liquidate loans prior to requesting purchase. This is an essential component if we are to maximize our resources and manage for results.

As we continue to grow the loan portfolio, the need to provide sufficient infrastructure to manage our risk is essential. We want to continue to strengthen and support the lender oversight and risk management functions of the Agency. We recently appointed a new Associate Administrator for Lender Oversight and have committed necessary resources to that function. We are also determining the most efficient structure for the Lender Oversight organization to fully utilize the tools and monitoring systems available to oversee our lenders. These lender oversight tools are also being utilized to more effectively set budgets and predict future trends.

We have a state-of-the-art loan and lender monitoring system (L/LMS) that incorporates best practices of the industry. As part of L/LMS, we have developed and are introducing the concept of lender risk ratings using both historical performance and future performance (as measured in part, by credit scores) and are now able to evaluate every SBA lender on a quarterly basis. Since 67% of our lenders have less than $1.0

million in SBA loans, this is the most efficient means of evaluating and measuring the risk each of these low-volume lenders poses to the SBA. The L/LMS allows us to focus our oversight efforts on those lenders with the poorest performance.

Lender risk ratings (L/LMS) also allows us to prioritize on-site reviews so those with the poorest performing lenders are reviewed first and, if ratings decline, attention can quickly be focused on those lenders. Soon we expect to introduce a lender portal, which will allow lenders to access their risk ratings and related performance data on-line, and we will provide an opportunity for lenders to review and comment on the rating components.

Last fiscal year, Congress gave SBA significant enforcement authority over Small Business Lending Companies (SBLCs), including power to issue cease and desist orders. In addition, the Administrator established the infrastructure for oversight activities within the Agency and issued Delegations of Authority for the Office of Lender Oversight. He also established the Lender Oversight Committee and the Portfolio Analysis Committee as key vehicles to ensure that the Office has adequate independence. These were significant actions that have a direct impact on how oversight is being conducted at the SBA.

All of these developments have improved our regulatory structure for oversight and enforcement. The enforcement authorities provided by Congress, the Administrator's Delegations of Authority, the creation of the two committees and the implementation of the loan and lender monitoring system have fundamentally improved SBA's oversight capabilities.

In conclusion, we are very proud of the growth in the programs and our efforts to ensure that this growth is managed in a reasonable and prudent manner. Today, SBA is helping more small businesses meet their financing needs than ever before.

Thank you for your time today, Mr. Chairman, Ranking Member and members of the Committee. I would be happy to answer any questions.

NASBIC
America's Small Business Partners

Statement
of
Lee W. Mercer

President

National Association
of
Small Business Investment Companies

Before The

United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Finance and Exports

March 9, 2006

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Chairman Bradley, Representative Millender-McDonald, members of the Subcommittee:

I appreciate the opportunity to testify today on behalf of the National Association of Small Business Investment Companies (NASBIC) regarding the status of the Small Business Investment Company (SBIC) program. NASBIC is the only professional association dedicated to representing the interests of all licensed SBICs. We hope our views are helpful to the Subcommittee as it considers the issues we will address today.

By way of background, there are currently 407 active SBICs: 178 Participating Security SBICs (designed to provide equity capital to U.S. small businesses); 128 Debenture SBICs (designed primarily to provide subordinated debt financing to small firms); 74 unleveraged bank SBICs (a subset of SBICs substantially reduced in importance since the passage of the Gramm-Leach-Bliley Act in 1999); and 27 SSBICs (100% minority focused debt providers "grandfathered" under the provisions of the 1996 legislation that closed the program to new licensees). By far the most important SBICs in terms of dollars invested in small businesses are the Participating Security SBICs and the Debenture SBICs. Of the $2.9 billion invested by SBICs in 2,299 small businesses in FY 2005, Participating Security SBICs invested $1.6 billion (55%) and Debenture SBICs invested $1.1 billion (38%). Together they accounted 93% of all dollars invested. Bank SBICs accounted for slightly over 6% of dollars invested and SSBICs accounted for the remaining 1% of the total. Additional information about the SBIC program is attached as an appendix to this testimony.

As requested, I will focus on changes, or lack thereof, that have occurred in the SBIC program over the past two years, the Administration's FY 2007 budget proposal, and suggestions for the reauthorization legislation that is projected for this year.

A. The Status of the Debenture SBIC Program

1. The Debenture SBIC program is very stable at present. It enjoys the strong support of both the Administration and Congress. The 128 active Debenture SBICs manage a total of $4.9 billion in total committed capital resources. There were 11 new Debenture funds licensed in FY 2005 and SBA anticipates licensing as many as 15 new Debenture SBICs this fiscal year, FY 2006. The subsidy rate remains at "zero" and has required almost no adjustment in fees or interest paid by Debenture funds over the past two years to maintain that rate. Given the situation with respect to the Participating Security program, the Debenture SBIC program has represented the only real opportunity to increase the impact of the SBIC program with respect to future investments in U.S. small businesses.

2. The Administration has proposed $3 billion in new leverage availability for the Debenture SBIC program in its FY 2007 budget submission. Based on current and projected usage, that will meet the needs of existing and new Debenture SBICs through the end of FY 2007. NASBIC supports the Administration's proposal for FY 2007 Debenture leverage availability.

3. Where we part company with the Administration is on its proposal to charge Debenture SBICs substantial fees to subsidize SBA administrative costs. The proposal is vague and

even SBA has been unable to tell us the particulars of the Administration's proposal. For example, the budget submission states that a 0.64% fee would be charged on all "loans" over $1.0 million. SBA has subsequently said that the fee would apply to "commitments." Commitments are not loans. However, if the proposed fee were to apply to all commitments (it being difficult to believe the Administration would allow SBICs to divide all their commitments in to sub-$1.0 million pieces), an averaged size Debenture fund would pay approximately $256,000 in fees over the life of the fund. That is a significant amount.

4. Such a change would very unfair to existing SBICs. When they raised money to start their funds, their investors knew there would be a subsidy rate risk and a credit risk. However, they were not told there would be a risk that the SBIC would have to fund part of the administrative cost structure of SBA—in a way that would also increase the SBIC's credit risk. This is different from the 7(a) and 504 programs (with substantially lower proposed fees) where each new loan stands on its own and a borrower can decide whether or not to enter into the transaction at the time the loan is considered. With the SBIC program, the borrower (the SBIC) is locked into an SBA-approved business plan that will run at least 10 years. To unilaterally add a major new category of cost in the middle of the game is unfair at best and a breach of contract at worst.

5. Such a change would also have a substantial negative impact on the formation of new funds. Since fund managers can have no impact on SBA's administrative budget, the change would introduce a substantial variable cost that cannot be controlled by fund managers. Few investors would be willing to risk million of dollars in a deal with open-ended costs (SBA says they want to pass all fully loaded administrative costs on to the borrowers) that cannot be quantified. The proposed fees would reduce substantially the number of fund managers and investors who would be willing to apply for a new Debenture license. Small businesses would suffer accordingly. NASBIC strongly opposes the Administration's fee proposal.

B. The Status of the Participating Security SBIC Program

1. The Participating Security SBIC program has been closed to new licensees for two years; the last new funds were licensed in FY 2004. The program will ramp out of existence if no legislative action is taken to save the program.

2. The Administration gave two reasons for "closing" down the program. First and foremost, the Administration said that the program did not meet the requirements of the Federal Credit Reform Act (FCRA) for a credit subsidy program eligible for credit scoring that offsets current costs with estimated future revenues. Without that qualification, an appropriation equal to 100% of any desired program level would be required on an annual basis. Clearly that would be a non-starter for the Participating Security program, or any SBA finance program. The second reason given was an unacceptably high subsidy rate that would apply even if the program met the

requirements of the FCRA; a rate substantially attributable to losses from the recent recession. With the economy growing, that subsidy rate has been falling.

3. The reason given by the Administration for the past two years for non-qualification with FCRA was that the Administration considered Participating Securities "equity" securities. Qualifying FCRA securities must be "debt" securities. Thus, for the past two years the industry and the House and Senate committees on small business have tried to design legislation that would pass muster with the Administration's definition of "debt" securities and adjust the "economics" of the program so as to merit a "zero" subsidy rate. The most recent efforts are represented by H.R. 3429 introduced by Mr. Manzullo and S. 1923 introduced by Senator Snowe.

4. But for the Administration's insistence that Participating Securities are non-qualifying "equity" securities, the House and Senate committees and NASBIC would not have spent the last two years trying to come up with an alternative to save what has been a very successful program in terms of its mission in stimulating equity investment in U.S. small businesses, including early stage investing. Rather, the time would have been spent amending some of the "economics" of the program to reduce risk of loss to the government and return the subsidy rate to zero.

5. Now the Administration has stipulated that Participating Securities are "debt" securities. It did this in a memorandum to SBICs dated January 12, 2006. Specifically, the Administration's new position is as follows:

   > "The FASB [Financial Accounting Standards Board] has issued **FAS 150**, 'Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.' SBA's view is that this Statement requires the outstanding principal balance of Participating Securities to be reported as a liability [debt]. SBA expects to issue a revised Form 468 in 2006, classifying outstanding Participating Securities as a liability [debt] to conform to this requirement."

6. This change of position by the Administration is a major development insofar as saving and reforming the many excellent aspects of the Participating Security program. If Participating Securities are "debt" securities the program qualifies under the provisions of the FCRA for credit scoring purposes. It seems inconceivable that the Administration would disavow both FASB and its own stipulations on this point. Even if the Administration were to take such a position, Congress, as author of the FCRA, would be within its authority to stipulate in an amendment to the Small Business Investment Act that Participating Securities are "debt" securities for all purposes related to qualification under the terms of the FCRA.

7. The importance of this development cannot be understated. A whole body of regulations and operating experience has been built up around the Participating Security program since its FY 1994 inception and the program continues to run smoothly with respect to those funds licensed prior to FY 2005. It is far easier to refine the financial structure of

the existing program than it is to start the whole process over again. Of importance in this regard is the fact that FY 2004 Participating Securities now carry a subsidy rate of 19.15%, down from the high Administration "re-estimated" rate of 51.36% for FY 1999 Participating Securities. The substantial difference shows that a major portion of the subsidy rate relates to economic climate and not solely to the structure of the Participating Security program.

8. It is possible to fix the current "economics" of the Participating Security program. The proper questions for the Administration now are simply: (a) what would the subsidy rate be for FY 2007 Participating Securities under current law; and (b) what changes does the Administration propose that would reduce that rate to zero? Perhaps all that needs to be done is to amend the current Participating Security "economic" provisions with those of H.R. 3429 or S. 1923. Whatever the approach, NASBIC stands ready to work with the Committee to save the best aspects of the Participating Security program however that is best accomplished. The changes would apply to funds licensed after September 30, 2006.

9. The need for the Participating Security program was confirmed by the full House Committee on Small Business in its 2005 hearing on the issue. A "restart" of the Participating Security program would be a breath of fresh air for the small businesses seeking relatively small amounts of equity capital for start-up or growth purposes—capital that is available, if at all, in very scarce supply.

10. Of equal importance, there are existing Participating Security SBICs that will not have the SBA-guaranteed leverage that was anticipated in their business plans as approved by SBA in the licensing process. Although Participating Security SBICs hold $3.6 billion in commitments as a group, those commitments expire between now and September 30, 2008, long before the SBICs anticipated needing the leverage in their business plans. With no new leverage available, the funds are literally placed in a "use it or lose it" position that is untenable for both SBA and private investors in the SBICs. The extent of the problem is estimated to be approximately $400 million. If unable to access that leverage when needed, the effected funds will have less diverse portfolios (increasing risk of fund failure) and less money to invest in existing portfolio companies (increasing risk of failure for the very small businesses the program is designed to support). Failure to solve this problem will constitute a breach of the implicit promise made in the licensing process that leverage sufficient to fund approved businesses plans would be available so long as those funds remained in regulatory compliance.

11. NASBIC believes the "expiring commitment" problem can be solved by extending the period within which Participating Security commitments due to expire between September 30, 2006 and September 30, 2008 can be drawn upon. This would be a "one-time" legislative solution to a very unique problem related to the wind down of the last of the original class of Participating Security SBICs. We look forward to working with the Committee to craft a solution to this very important problem.

C. NASBIC Proposals for 2006 Reauthorization Legislation

NASBIC will submit suggested legislative language for each of the following proposals:

1. Incorporate the provisions of H.R. 3429 or an amendment of the "economics" of the exiting Participating Security program as discussed above to "restart" the SBIC equity investment program.

2. Extend the time for the exercise of Participating Security commitments sold to Participating Security SBICs in the years FY 2002, 2003, and 2004 to solve the "commitment expiration" problem discussed above. NASBIC proposes a three-year extension for each of the identified class of commitments.

3. Amend §306(a) of the Small Business Investment Act of 1958 to correct what appears to be the unintended results of the formula for calculating the maximum percent of its total capital, including all leverage, that an SBIC can invest in a single small business. The existing formula yield differing percentages depending on the leverage ratio. NASBIC's proposed amendment would create a formula that would be consistent in its application to all SBICs, irrespective of leverage ratios.

4. Amend §303(g)(12) of the Small Business Investment Act of 1958 to clarify the rules that apply to distribution of publicly traded, marketable securities held by Participating Security SBICs due to successful portfolio company public stock offerings. The clarification would correct the current situation which has seen SBA unilaterally change the rules applicable to such distribution to the detriment of the program.

5. Amend §303(d) of the Small Business Investment Act to require that the Administrator require each licensee, as a condition of an application for leverage, to certify in writing that not less than 25% of the licensee's aggregate dollar amount of financings will be provide to smaller enterprises. This would replace the current requirement that a base of 20% be invested in small businesses plus 100% of investments made with leverage in excess of $90 million. The change would simplify record keeping and administration while increasing the across-the-board requirement applicable to all SBICs.

In conclusion, thank you for your consideration of our views regarding the current status of the SBIC program and our suggestions for legislative changes that would improve the program and its ability to serve U.S. small businesses across America. We look forward to working with the Committee during the months ahead to further develop our ideas with the hope that they might be included in reauthorization legislation to be passed this year. I would be pleased to answer any questions you may have concerning my testimony or regarding any other issues having to do with the SBIC program.

The U.S. Small Business Investment Company Program

- The U.S. Small Business Investment Company (SBIC) program was created by Congress in 1958 to help small U.S. businesses meet their requirements for growth and operating capital not available through banks or other private capital sources. Small companies often require financing in the critical $250,000 to $5 million range in the form of either subordinated loans not made by banks or equity investments not generally available from non-SBIC private equity firms. SBICs fill that gap—supporting thousands of U.S. small businesses each year.

- The SBIC program is a unique partnership between the public and private sectors. SBICs are private equity funds that invest in U.S. small businesses that meet size and operational criteria set by the federal government. SBICs are licensed and regulated by the U.S. Small Business Administration (SBA), but privately managed by private sector management teams whose qualifications and business plans are approved in advance in a rigorous licensing process. Minimum capital required to start an SBIC—$5.0 million—must come from qualified private investors. Additional capital—as much as three times the private capital—is then potentially available to each SBIC through SBA by sale of SBA-guaranteed securities on an "as needed" basis to support fund investments and expenses. The private capital is at risk in its entirety before any taxpayer money is at risk, and SBA examines SBICs regularly to ensure their financial soundness and regulatory compliance.

- Since its beginning in 1958, the SBIC program has provided approximately $46 billion of long-term debt and equity capital to more than 99,000 small U.S. companies, with $2.9 billion invested in 2,299 small U.S. companies in FY 2005 alone. Many well-known U.S. companies received early financing from SBICs, including Intel, Apple Computer, Callaway Golf, JetBlue Airways, Whole Foods Market, Palm Computing, Staples, Quiznos, Federal Express, Outback Steakhouse, Costco, Mothers Work, and Build-A-Bear Workshop. Eleven of the top 100 companies on the latest *Inc. 500* list of America's fastest-growing private companies received SBIC financing (November 2005), as did eight of the top 100 "Hot Growth Companies for 2005" featured in *BusinessWeek* (June 6, 2005), three of the nine members of *BusinessWeek*'s "Hot Growth Hall of Fame," and six of *Fortune* magazine's "100 Best Companies to Work For" (January 23, 2006).

- More than 40% of all SBIC investment dollars in FY 2005 went to companies that had been in business only three years or less at the time of the investments. SBICs are a crucial source of capital during those difficult early years.

- Small businesses receiving SBIC financing in FY 2005 employed approximately 218,000 individuals—an average of 95 employees per company—at the time they received the SBIC financing. The median number of employees in SBIC-financed companies was 34.

- SBICs play an important role in financing local businesses in states and geographic regions not generally served by non-SBIC private equity firms. Of the 2,299 U.S. small businesses that received FY 2005 SBIC financing, 23% were located in government-designated Low- and Moderate Income (LMI) areas of the country. Those LMI-district companies received $543 million (19%) of the total $2.9 billion invested by SBICs in FY 2005.

- SBICs are playing a vital role in our continuing economic recovery from the last recession—especially in the manufacturing sector. Of the $2.9 billion in SBIC investments in FY 2005, 30% were made in hard-pressed small U.S. manufacturing companies. For the period FY 2001 through FY 2005, SBIC investments in small manufacturing companies totaled $4.3 billion.

Revised February 2005

Lee W. Mercer

Lee Mercer is president of the National Association of Small Business Investment Companies, having joined the association in that capacity in 1996. SBICs are government-licensed, government-regulated, but privately managed private equity firms that invest a combination of private and government-guaranteed capital in U.S. small businesses that meet size and operational requirements promulgated by the government. As of December 31, 2005, there were 412 SBICs managing $23.2 billion in capital resources—$2.9 billion of that having been invested in 2,299 companies in U.S. FY'05. NASBIC represents the interests of the SBIC industry before the U.S. Congress and applicable federal agencies and provides other professional, educational, and meeting services for industry members.

Lee held several positions in both the private and public sectors prior to joining NASBIC. In the private sector, Lee was a partner in a New Hampshire law firm, a senior program manager and government affairs representative for Digital Equipment Corporation, and president of two privately owned small businesses. In government, he served first as legislative director and counsel for former U.S. Senator Warren Rudman (R-NH) and then as deputy undersecretary of the U.S. Department of Commerce during parts of the administrations of Presidents Ronald Reagan and George H. W. Bush—first with the Export Administration and then the Technology Administration. While with Senator Rudman, Lee was the primary manager of the legislative campaign that resulted in the creation of the Small Business Innovative Research (SBIR) program, the program that provides more than $2.0 billion per year in federal research and development contracts to small, technology-based U.S. companies.

During his career, Lee has represented the U.S. government and private interests in several international settings and has served as a director of several private companies and as a member of several government advisory boards. He received his BA degree from Dartmouth College and JD and LLM degrees from the Boston University School of Law. He served in the U.S. Marine Corps from 1966 to 1968. He has three sons and lives in Arlington, Virginia with his wife Deborah. Lee can be reached at his office by phone at 202-628-5055 or by e-mail at lmercer@nasbic.org.

NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

Oversight of the Small Business Administration's Finance Programs

Testimony Before the Subcommittee on Tax, Finance and Exports of the House Committee on Small Business

Thursday, March 9, 2006

Submitted by
Anthony R. Wilkinson
President and Chief Executive Officer

The National Association of
Government Guaranteed Lenders, Inc.

P.O. Box 332
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NAGGL Gets It.

Testimony Before the Subcommittee on Tax, Finance and Exports of the House Committee on Small Business

March 9, 2006

Mr. Chairman and members of the subcommittee, my name is Tony Wilkinson. I am President and CEO of the National Association of Government Guaranteed Lenders (NAGGL) a trade association of more than 650 lenders who participate with the Small Business Administration in delivering the agency's 7(a) loan program. We appreciate the opportunity to testify today on the administration's proposed FY 2007 budget and on the 7(a) program reauthorization that is required this year.

Since 1992, the Federal Credit Reform Act and a program's annual subsidy rate calculation required by that law has driven policy deliberations for all SBA credit programs, including the 7(a) program. This year is no exception. The budget portends the policy decisions that the Small Business Committee and its Senate counterpart will have to make, the sooner the better.

The fiscal year 2007 budget submission shows that under current law SBA is at the end of the road in exercising its discretion to increase lender fees in order to maintain the credit subsidy rate at zero. The subsidy rate

calculation, a net present value calculation under which the cost of the program is calculated based on revenue raised (from guarantee fees from lenders and borrowers) minus defaults, requires that effective October 1, the program's ongoing lender fee on the outstanding balance of all new loans be raised to 0.55 percent, the maximum allowed under the statute. The budget also announces administrative changes in the program's operations that will reportedly improve cash flow under the credit reform model. But, SBA has no legislative authority to make any further fee increases that might be necessary to keep the subsidy rate constant or to improve it.

This policy perspective of SBA is critical. The budget indicates that the SBA has to increase the ongoing fee this year and make other minor program operation changes because the FY 2007 subsidy rate increases due to a decrease in the average size of 7(a) loans being approved. Specifically, since the year 2000, the number of loans under $150,000 made in the program has increased from 60 percent of the total portfolio and 18 percent of dollar value to 78 percent of the total loan portfolio and 25 percent of the total dollar value of loans in 2005.

Under current law, borrowers pay a guarantee fee based upon the amount of the loan. Smaller loans, those loans under $150,000, have a smaller

guarantee fee (2 percent) than larger loans. Loans in the $150,000 to $700,000 range have a 3 percent guarantee fee, and loans over $700, 000 have a 3.5 percent guarantee fee. In addition, any guarantee in excess of $1 million carries an additional ¼ of 1 percent guarantee fee. It is significant that the budget clearly shows, as NAGGL has long argued, that the large loans subsidize small loans. This

subsidization is coming home to roost. According to the budget, the average guarantee fee for the entire portfolio has now declined from 2.16 percent to 2.09 percent. In other words, the government is getting less up-front income from loans today than it has over the last several years.

This dilemma in which SBA has authority to modify the program's fees or operations to respond to a further decline in the average guarantee fee means the situation has to be addressed, and as I said, the sooner the better. The options available are: for the program to receive an appropriation, for this committee to further increase fees, or for the committee to increase the current maximum loan size cap from $2 million to $3 million as NAGGL suggests in its proposed legislative package (see attachment). NAGGL thinks it is improbable that Congress will appropriate dollars for the program in light of current budget restraints. NAGGL would oppose any further fee increases—as the budget indicates, over the last 10

years, lenders and borrowers have already unnecessarily paid $800 million too much in fees given the projected subsidy rate in each appropriate time period. Lenders will not accept paying more fees when the government has regularly overcharged program participants. This leaves an increase in loan size that will allow larger loans to generate more fee income for the government than smaller loans. This is the best available option to cope with

declining fee income to the government—and is a remedy the lending industry believes the Committee should adopt.

Before commenting further on reauthorization issues, I would like to address another aspect of the FY 2007 budget submission. The administration proposes imposing a new administrative fee on loans over $1 million to pay for the operations of the Office of Lender Oversight. NAGGL opposes such a fee. Over the last several years SBA has undergone significant change with a manifold decrease in personnel. This proposed administrative fee appears to be an attempt to get the private sector to fund what was previously a government function—lender oversight. If this fee is approved, what will come next, a fee to pay for the

administrator's salary and travel or other administrative expenses? No, there is a principle involved in our opposition to this proposed fee. Most broadly stated, if SBA wants to move towards a government sponsored enterprise, then we should have that debate. Let's not proceed down that course without proper dialogue and debate.

Mr. Chairman, NAGGL's proposed reauthorization language is attached to my testimony. The components of the package are:

- An increase in the maximum loan size to $3 million and an increase in the maximum guaranteed portion to $2.25 million.

- An authorization level of $18 billion in FY 2007 and $19 billion in FY 2008. The administration proposes a level of $17.5 billion in FY 2007, which the lending industry finds acceptable.
- Creating standards for a National Preferred Lenders Program. SBA is in agreement with NAGGL on this proposal and is attempting to address the issue administratively. If adopted, it would significantly streamline and improve program operations. No longer would PLP decisions be made haphazardly across the country at the district office level without a uniform standard for decision-making.

- Permitting the use of the 504 program alternative size standard for loans made in the 7(a) program. This would allow borrowers with a maximum net income of $7 million and a maximum net worth of $2.5 million to receive 7(a) loans. We see no reason for these borrowers to be eligible for 504 loans and not 7(a) loans as is now the case.

Before I conclude, let me stress the importance of legislation to authorize program levels for fiscal year 2007 and at least one, preferably two, additional years. Historically, in drafting the appropriations' bill, the Appropriations Committees have deferred to the amount of loans recommended by the Small Business Committees and simply included language approving the level

specified in section 20 of the Small Business Act. There is no level authorized for 2007. In prior years when there has been no authorized amount, the appropriations' bill includes what we term a "hard cap" or a specific maximum amount. Unfortunately, normally the amount of this cap is the amount requested by the administration. Should there be a demand above that maximum amount, it would be necessary for the appropriation law to be amended—and we all know how difficult that is. Please provide

some flexibility and enact an authorization bill before the appropriations' bill is completed.

Mr. Chairman, we appreciate the opportunity to testify today and would be pleased to answer your questions.

Attachment A:

Bill Summary

PREFFERED LENDERS PROGRAM

Section 2 codifies the existing preferred lenders program (PLP) in a new section 7(a)(32) of the Small Business Act.

It also authorizes a new National Preferred Lenders Program for PLP lenders who meet the following criteria:

- The lender has operated satisfactorily as a PLP lender in at least five SBA territories for a minimum of three years in each territory;
- The lender has satisfactorily centralized loan approval, loan servicing and loan liquidation functions and processes;
- The lender has uniform written policies and procedures;
- The lender maintains organizational operating statistical data which meet or exceed the average rate for all participating lenders on a national basis for loan currency, defaults and recoveries; and
- The lender, after audit and examination, achieves a "generally satisfactory" or "substantially satisfactory" classification as a preferred lender and a Small Business Loan Company, if applicable, after being afforded a reasonable opportunity to improve any deficiencies identified by such audit or examination.

MAXIMUM 7(a) LOAN AMOUNT

Section 3 increases the maximum net or guaranteed amount of a 7(a) loan to $2.25 million (now $1.5 million) and increases the maximum gross loan amount to $3 million (now $2 million).

7(a) PROGRAM AUTHORIZATION

Section 4 provides a program authorization for 7(a) loans for fiscal year 2007 of $18 billion and for fiscal year 2008 of $19 billion (FY 2006 is $17 billion).

ALTERNATIVE SIZE STANDARD

Section 5 requires SBA to establish an optional size standard which is applicable to both 7(a) borrowers and 504 borrowers, utilizing net worth and net income in lieu of industry standards.

In addition, it provides that until the Administrator does so, the alternative standard in the Code of Federal Regulations for 504s (maximum net income of $7 million and maximum net worth of $2.5 million) shall also apply to 7(a).

ATTACHMENT B:

Draft Bill Proposal

To facilitate the delivery of financial assistance to small businesses under section 7(a) of the Small Business Act, and for other purposes.

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A Bill Proposal

By

The National Association of Government Guaranteed Lenders

A BILL

To facilitate the delivery of financial assistance to small businesses under section 7(a) of the Small Business Act, and for other purposes.

SEC. 2. PREFERRED LENDERS PROGRAM

(a) IN GENERAL - - - Section 7(a) of the Small Business Act (15 U.S.C. 636(a)) is amended by adding the following new paragraph at the end thereof:

"(32) PREFERRED LENDERS PROGRAM. - - -

"(A) IN GENERAL. - - - There is hereby established a Preferred Lenders Program for lenders who demonstrate their knowledge of Administration laws and regulations concerning the 7(a) guaranteed loan program and their proficiency in program requirements. In order to participate in the program, a lender shall demonstrate that it (i) has the ability to process, close, service and liquidate loans, (ii) has the ability to develop and analyze complete loan packages, and (iii) has a satisfactory performance history of participation in the 7(a) program.

"(B) DELEGATED AUTHORITY. - - - Participants in the Preferred Lenders Program shall have and exercise delegated authority from the Administration to take actions as provided in the *proviso* of section 5(b)(7), including:

"(i) complete authority to make and close loans with a guarantee from the Administration without obtaining the prior specific approval of the Administration; and

"(ii) complete authority to service and liquidate such loans without obtaining the prior specific approval of the Administration for routine servicing and liquidation activities, but participants shall not take any actions creating an actual or apparent conflict of interest.

"(C) AREA OF OPERATIONS. - - - The designation of a lender to participate in the Preferred Lenders Program shall authorize the use of delegated authority in areas served by an identified district office or offices of the Administration.

"(D) NATIONAL OPERATION. - - - A participating lender may request designation as a national preferred lender by the Administration, and, upon such designation, shall have the authority to operate in every area served by an office of the Administration. The Administration shall confer designation as a national preferred lender if the Administrator determines that the lender meets the following eligibility criteria:

"(i) it has satisfactorily operated as a preferred lender in areas encompassing all or part of the territory in at least five district offices for a minimum of three years in each territory;

"(ii) it has centralized loan approval, servicing and liquidation functions and processes which are satisfactory to the Administration;

"(iii) it has uniform written policies and procedures;

"(iv) it has an average rate of performance for loans made under the preferred lenders program which is equal to or greater than the Administration's national average rate of all 7(a) loans in each of the following categories: currency rate, default rate and recovery rate; and "(v) it has received a generally satisfactory or substantially satisfactory compliance review rating from the Administration in its most recent audit and examination as a preferred lender and a small business lending company, if applicable, or an in compliance rating as a result of a follow-up review.

"(E) CORRECTIVE ACTION. - - - If a national preferred lender fails to continue to meet the eligibility criteria enumerated in paragraph (D), the Administration shall notify the lender of the deficiency and allow a reasonable period of time for the lender to again meet the criteria.

"(F) SUSPENSION OR REVOCATION. - - - The designation of a lender as a national preferred lender shall be suspended or revoked at any time that the Administration determines that the lender (i) is not adhering to its rules and regulations or (ii) has failed to continue to meet the eligibility criteria specified in paragraph (D), but such suspension or revocation shall not affect any outstanding guarantee.";

(b) CLERICAL AMENDMENT - - - Section 7(a)(2)(C) of the Small Business Act (15 U.S.C. 636(a)(2)(C)) is amended - - -

(1) by inserting in clause (i) "conducted pursuant to paragraph (32)" after the word "Program"; and

(2) by striking clause (ii);

(c) CONFORMING AMENDMENT - - - Section 7(a)(19) of the Small Business Act (15 U.S.C. 636(a)(19)) is amended by striking "the proviso in section 5(b)(7)" and inserting "section 7(a)(32)".

SEC. 3. MAXIMUM LOAN AMOUNT

Section 7(a)(3)(A) of the Small Business Act (15 U.S.C. 636(a)(3)(A)) is amended by striking "$1,500,000 (or if the gross loan amount would exceed $2,000,000)" and inserting "$2,250,000 (or if the gross loan amount would exceed $3,000,000)".

SEC. 4. 7(a) AUTHORIZATION FOR FISCAL YEARS 2007 AND 2008

Section 20 of the Small Business Act (15 U.S.C. 631 note) is amended by adding at the end the following:

"(f) FISCAL YEAR 2007. - - - For the program authorized under section 7(a) of this Act, the Administrator is authorized to make $18,000,000,000 in general business loans, and there are authorized to be appropriated to the Administrator such sums as may be necessary to carry out such program.

"(g) FISCAL YEAR 2008. - - - For the program authorized under section 7(a) of this Act, the Administrator is authorized to make $19,000,000,000 in general business loans, and there are authorized to be appropriated to the Administrator such sums as may be necessary to carry out such program.".

SEC. 5. ALTERNATIVE SIZE STANDARD

Section 3(a)(3) of the Small Business Act (15 U.S.C. 632(a)(3)) is amended by striking the period at the end thereof and inserting the following:

"Provided, That the Administrator shall establish an optional size standard which shall be applicable to both 7(a) business loan applicants and development company loan applicants and which utilizes maximum tangible net worth and average net income as an alternative to the use of industry standards: Provided further, That until the Administrator establishes such an optional size standard for business loan applicants, the alternative size standard in 13 CFR 121.301(b) shall also apply to business loan applicants.".

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program Status

& Proposed FY 2007 SBA Budget

Submitted to the

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON FINANCE AND EXPORTS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

Mr. Kurt Chilcott
President & CEO
CDC Small Business Finance
San Diego, Ca.

March 9, 2006

The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Committee on Small Business concerning the SBA budget proposed by the Administration for FY 2007 as well as the status of the SBA 504 Loan Guaranty Program.

NADCO is a membership organization representing over 250 Certified Development Companies (CDCs) who are responsible for the delivery of the SBA 504 program. NADCO's member CDCs provided more than 99% of all SBA 504 financing to small businesses in 2005, stimulating the investment of $12 billion in small business projects and the creation and retention of over 145,000 new jobs. CDCs are almost exclusively not-for-profit intermediaries with a statutory mission of economic development achieved through the delivery of the SBA 504 and other economic development programs and services customized to the needs of their respective communities.

NADCO's mission is to serve as the voice of the CDC industry and the 504 program with Congress and the SBA to ensure the sustainability of this industry and the 504 program. We provide advocacy, policy and technical support and educational services to the industry. We work closely with the SBA and our for-profit lending partners to continue to effectively deliver what is certainly the largest and most successful federal economic development finance program in history (over 1.4 million jobs, $25 billion in 504 loans and the leveraging of over $30 billion in private investment) We are passionate about our work to assist small businesses to become owners of their facilities and as a result create valuable jobs and investment and stability in our communities across the country.

NADCO would like to thank Chairman Bradley, Ranking Member Millender-McDonald, Committee Chairman Manzullo, Committee Ranking Member Velazquez, and the entire Committee, for continued support of the CDC industry and the 504 program. The Small Business Committee has worked closely with the Congressional leadership, SBA, and our industry to ensure the availability of this valuable economic development program to small businesses over the years.

NADCO's comments are divided into four sections:

1). SBA's proposed FY 2007 504 authorization
2). SBA's proposed new Business Loan Fee
3). NADCO's proposed CDC Modernization legislation
4). Additional Issues and Concerns.

504 FY 2007 Authorization:

The Administration has proposed an authorization ceiling of $7.5 billion for FY 2007, which is equal to the current FY 2006 ceiling. With 504 program demand by small businesses growing at a rate of almost 40% year-to-date, NADCO believes the proposed authorization to be inadequate.

FY 2006 demand is projected to exceed $7.0 Billion and this demand is expected to continue at a high level well into FY 2007. The proposed authorization request of $7.5 billion would provide for approximately 7% growth rate, far below the last three years growth rates of 28%, 26% and 26%. Clearly, the proposed authorization level will be insufficient to meet small business demand for the 504 loan program.

An insufficient authorization level can have disastrous effects on small businesses and the viability of the 504 program. SBA would be forced to either ration credit throughout the year, or even shut down the program late in the year. This cannot be allowed to happen. It is far preferable to have more than adequate authorization to ensure the availability of the program, the credibility of the SBA and the future of the SBA 504 program.

Furthermore, as the Committee knows, the 504 program has been at "zero subsidy" since 1997. This means that there is virtually no cost to the taxpayer for the program. It is paid for by user and lender fees. In fact, budget information provided by SBA reveals that the 504 program has actually provided excess fees to the U. S. Treasury over about $300 million since going off budget.

Given that there are no savings to the federal budget from an inadequate authorization level, we urge the Committee to increase the loan authority for FY 2007 to ensure that small businesses are not turned away by SBA. We request a minimum of $8.5 billion in loan authority - $1 billion more than the Administration's proposed figure.

Proposed New 504 Loan Fee:

The Administration proposes that a completely new user fee be added to the 504 program for FY 2007. The fee would be levied on all 504 loans that exceed $1 million, estimated by SBA to be at least 15% of our small business borrowers. The fee would be approximately 11 basis points or 0.11% of the guaranteed 504 second mortgage loan amount, according to SBA sources. While it is unclear how this fee would be levied, it will be the small businesses, either directly or indirectly, that will be burdened with this additional cost.

NADCO is strongly opposed to this new fee on small businesses and supports the opposition of the House Small Business Committee as noted in the February 17, 2006 Committee letter to the House Budget Committee. NADCO urges the Committee to make the removal of this fee from the proposed FY 2007 budget a top priority.

NADCO has a number of concerns regarding this fee proposal. First, it places an additional burden on thousands of small businesses and fundamentally increases their cost of capital. This results in less capital available to grow their businesses and create jobs and investment in their communities. It will also likely lead to a diminished demand for the SBA 504 program, denying access to small businesses of this important affordable business ownership program.

Second, the fee represents the proverbial "camel's nose under the tent" that once enacted opens the door for the SBA to pass unsubstantiated "administrative costs" on to its financing programs and ultimately the nation's small businesses in future years. This fee sets a dangerous precedent that should not be allowed to transpire.

Third, the fee could well lead to the entire loan administration process being "off budget", and therefore no longer under the oversight of Congress. Allowing the capital access programs of the SBA to be supported by "non-appropriated user fees" could ultimately result in the formation of another off-budget Government Sponsored Enterprise, or GSE, with unlimited authority to modify its programs and operations without any review or oversight by Congress.

Finally, there are a number of unanswered questions regarding this fee that the SBA has yet to address. NADCO is concerned that there has not been an accurate and thorough disclosure of SBA's administrative costs that are to be paid for by this fee, of the calculations used to determine the fee and of the manner in which it is to be applied and implemented.

For all these reasons, NADCO urges the Committee to oppose this new fee on small businesses.

Proposed CDC Modernization Legislation:

The CDC industry through the 504 program continues to provide small businesses with access to long term, fixed rate, low cost capital, through which these small businesses create hundreds of thousands of new jobs. With no cost to the taxpayer, 504 is without question, one of the most productive and effective Federal loan guaranty programs.

In the last several years, however, the SBA, the CDC industry and the 504 program have experienced unprecedented structural changes that have had tremendous impact on the delivery and the future of the504 program and the CDC industry. This includes two major changes – the centralization of all 504 loan processing, loan servicing and liquidation functions from 70 SBA district offices to one or two centers in the country, and the "deregulation of the industry" that provides for every CDC a minimum statewide area of operations for delivery of the program.

The impacts of these changes are very much still being felt and the implications for the industry and its future are becoming clearer as we have more experience and are able to see the results of these fundamental changes. This is why we believe it is critical that Congress examine the program and industry at this time and set a statutory course that ensures the intent and mission of CDCs and the 504 program for the future are clearly established. This will allow the Agency that has implemented these changes through the regulatory process to take the steps to meet the statutory intent from Congress for the program and the industry into the future.

NADCO has undertaken a strategic planning process that we believe helps to set the course for the future of the CDC industry and the SBA 504 program. Therefore we propose that the following steps be taken through the legislative process as outlined in our legislative proposal – The CDC Modernization Act:

- Clearly establish the intent and mission of the CDC industry and the 504 program as economic development

- Recognize and preserve the value of CDCs as non-profit economic development intermediaries that are an essential and highly successful element in Congress' and SBA's strategy to assist small businesses to create jobs and investment in all our communities. Reconfirm the statutory intent of CDCs (local and state development companies) as originally established in 1958 to provide small business programs, services and assistance that for-profit lenders do not and should not provide.

- Prohibit the SBA from continuing to promote any duplication between its major lending programs – 7a and 504 – that have always had very different missions, structures and benefits to our small business program infrastructure. These programs are both very much needed and deserving of support, but they serve different purposes and meet different small business needs.

- Direct the SBA to collect and publish information on all the benefits of the SBA 504 program including the public policy goals such as assistance to women, minority and veteran owned businesses and on the full range of services and programs provided by the CDC industry as outlined in their required Annual Reports to SBA.

- Ensure that expansions of CDCs to contiguous states are completed in a timely manner, but more importantly that they conform to the local economic development intent and accountability that represent the core values of the CDC industry and the 504 program.

- Clearly establish, expand and report on the community and public policy goals of the 504 program. Currently these include expansion of exports, minority, women and veteran-owned business assistance, rural development, manufacturing businesses, and areas impacted by Federal budget cutbacks. NADCO proposes adding low income communities in order to provide expanded access to capital for businesses in these areas.

In addition in order to increase the effectiveness of the CDC industry and the 504 program, we have included the following program improvements in our legislative proposal.

- Combined Public Policy Business Ownership: Narrow regulatory interpretation by SBA has led to otherwise-qualified borrowers under two public policy directives not being allowed to take advantage of the larger loan amount of $2 million. We ask

Congress to provide more specific guidance to SBA in order to expand this regulatory interpretation.

- Limited Debt Refinancing: Some potential small business borrowers have existing higher priced mortgages on their facilities that should be refinanced as a part of their expansion strategy. These small businesses should have limited access to the SBA 504 program for refinancing purposes when it is a part of an expansion project.

- Program Fee Adjustment: First mortgage lenders currently pay a 1/2% one-time fee to SBA as their contribution to the program cost. This fee is then passed on to the small business borrower through higher rates or fees on their permanent or interim loans from the lender. We request that this fee be amortized over the life of the 504 loan and split between the small business and the CDC. This will lower the upfront costs to the small business and further encourage bank and non-bank lenders to participate in the program.

- Financing Closing Costs: In order to save small business borrowers up-front cash for use as working capital, we request that Congress enable them to finance their 504 closing costs in the loan, just as most homeowners are able to do for their residential loans.

- Combined 504 & 7(a) Loans: Small businesses need both long term fixed asset financing through the SBA 504 program and more general shorter term working capital and equipment financing through the SBA 7a program. Small businesses should be able to utilize both SBA loan guaranty programs to their maximum amount. This will allow small businesses to meet their full range of capital needs for both short and long term financing.

- 504 Loan Liquidations: We request that Congress direct SBA to require that 504 defaulted loan liquidations and recoveries be processed by CDCs or their outside contractors, and that CDCs be compensated for the costs of these recovery actions.

NADCO urges that the Committee review and adopt NADCO's proposed legislation. It is critical to take these steps at this point in time to ensure the future of this industry and the 504 program. We believe this will result not only in continued growth of the 504 program and the ability of small businesses to become owners, but to the expansion of other programs and services provided through the CDC industry for the purpose of economic development, job growth and investment throughout the country.

Additional Issues and Concerns

HR 3982

Recently, legislation was introduced (HR 3982 – Congressman Doolittle) that proposes to make several changes to the process by which CDCs can expand to other states and to the governance structure of Certified Development Companies. The NADCO Board of

Directors representing all ten regions of the country and CDCs, large and small, has unanimously voted to oppose HR 3982.

NADCO believe that this legislation is an attempt to circumvent both the statutory purpose of a development company and its accountability to the communities it is chartered to serve. Furthermore, it diminishes the local economic development mission of the CDC industry and proposes to change SBA regulations governing "Ethical Requirements for CDCs". NADCO does not believe that this bill will result in promoting greater access to the SBA 504 program for small businesses or to improvements to CDC efficiency.

NADCO's concerns regarding this proposed legislation have been detailed in correspondence to and discussion with the Ranking Members of the Small Business Committee. We urge the Committee to join NADCO and the CDC industry in opposing this legislation that would lead to the "franchising" of CDCs across the country and violate the basic statutory and regulatory purpose of a Certified Development Company and the delivery of the SBA 504 program.

Competition

In 2004, SBA adopted regulations that dramatically changed the landscape of the CDC industry, allowing for state and multistate area of operations for all CDCs. As NADCO noted in its extensive comments on this regulatory process, this increased competition has the potential to generate both positive and negative results. While there has been no comprehensive examination of the results of these changes by the SBA, it appears that the CDC industry is experiencing program growth in many areas of the country. There have been numerous requests by CDCs to expand, particularly through the Local Economic Area process.

However, NADCO is concerned that not all the results have been positive and that the SBA has neither a plan nor the capacity to deal with the negative consequences created by these regulatory changes. Perhaps, our largest concern relates to the credit quality and standards of the industry. Since a relatively small number of CDCs are responsible for a very high proportion of SBA 504 production, changes in credit standards by even one or two CDCs can have a dramatic impact on our subsidy rate and the cost of the program for our small business borrowers. Currently SBA's oversight only occurs well after the credit decision has been made and the potential damage has been done. We urge the Committee to ensure that SBA is taking all steps necessary to protect both the credit quality and conformance with SBA regulations designed to minimize abuses in the loan approval process and the credit quality of the loans being approved.

NADCO is also concerned that as a result of increased competition, not all communities within a CDCs Area of Operations are being served. This is particularly true for rural areas where the cost of delivering the program is higher and there is a much lower potential for new projects and a higher risk of loss. SBA must ensure that these areas are being served as part of a CDCs charter responsibility.

Finally, NADCO is concerned that this increased competition is blurring the lines between non-profit and for-profit lending practices. A CDC with contract loan officers working out of their homes and no connections or accountability to the communities they are operating in does not meet the statutory intent for CDCs or the 504 program. In addition, in many instances, increased competition, rather than providing more choice to the small business, has increased choice for the banks and non-bank lenders. While on the surface this may seem to be a positive development, in practice banks are forcing CDCs to adopt credit standards and project structures that may not be in the best interest of the small business, the SBA or the CDC industry or face losing these banks as lending partners.

SBA and Congress must ensure that the statutory intent and integrity of the CDC and the 504 program is being met in this new era of increased competition and that CDCs are being held accountable for meeting this intent not only through the responsible delivery of the SBA 504 program but through their reinvestment in economic development programs and services in the communities they serve. NADCO's proposed legislation seeks to address these significant challenges and to preserve the not-for-profit economic development mission of the CDC industry. Again, we urge the Committee to adopt our proposed legislative proposal as a part of the program reauthorization process.

Liquidation Regulations

SBA has recently published a proposed regulation containing procedures for 504 and 7a loan liquidations. Despite numerous meetings with senior SBA officials on this important regulation draft, it contains neither of NADCO's primary recommendations.

NADCO's first major recommendation is to make CDC participation in the liquidation of its defaulted loans mandatory for all CDCs. CDCs could use their own staff or be able to contract for these services from a qualified firm that had been approved by SBA. NADCO's second recommendation was that CDCs be compensated by SBA for this work whether performed internally or externally.

The reason for our first recommendation is clear: SBA has eliminated nearly all its portfolio management field staff that used to perform 504 liquidations. NADCO continues to express our concern to the Agency regarding the lack of progress and tracking on current defaulted SBA 504 loans and has urged the Agency to take all steps possible to ensure that the liquidation responsibility is transferred to the CDC to ensure the best possible recovery rates.

The justification for our second recommendation is also clear: the fee structure for 504 that dates back to 1986 was not created to cover the costs of CDCs working on loan liquidations. It was created to cover normal loan processing and servicing. Loan liquidation and collateral recovery are frequently very time-consuming and labor-intensive activities. SBA should not transfer the responsibility without also providing for the cost of fulfilling that responsibility.

For these reasons, NADCO requests the Committee to pass the provisions of our CDC Modernization bill that require SBA to make these two changes to its proposed liquidation regulation. Without these additions, we believe that it will be very difficult to successfully complete liquidations and recoveries that meet OMB requirements and maintain the low borrower fees now in place.

Conclusion:

Through the 504 program, SBA provides the largest, most successful and lowest cost economic development program within the Federal government. Its real value to America is immeasurable. Through the jobs it helps create and the small business growth it fosters, the SBA 504 program benefits employees, business owners, communities and governments at all levels.

With the CDC industry, SBA has created a valuable network of economic development lenders with expertise and resources that provide value and services and commitment that for-profit lenders cannot and should not provide. The CDCs accountability to the communities it serves, and their reinvestment in those communities must be preserved and enhanced or much of their unique value will be lost.

We urge the Committee to continue to support the growth of the 504 program and at the same time to preserve and enhance the economic development mission of the program and the CDC industry. This can best be accomplished by passing our proposed CDC Modernization Act during this session.

Again, we thank the Committee for its support of the CDC industry and the SBA504 program and look forward to another successful year of providing the opportunity of ownership for the nation's small businesses.

I would be pleased to answer any questions from the Committee.

THE SURETY ASSOCIATION OF AMERICA

Testimony of Lynn M. Schubert

Before the U.S. House of Representatives

Subcommittee on Tax, Finance and Exports
Committee on Small Business

"Oversight of the Small Business Administration's
Finance Programs"
March 9, 2006

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Subcommittee on Tax, Finance and Exports of the
Committee on Small Business of the United States House of Representatives

Oversight of the Small Business Administration's Finance Programs
Testimony of Lynn M. Schubert
March 9, 2006

Mr. Chairman, thank you for inviting us here today to testify on a matter that is critical to the surety industry, to the construction industry and to small and emerging businesses.

The Surety Association of America (SAA) is a trade association of over 500 insurance companies that are licensed to write surety and fidelity bonds. SAA members collectively provide the vast majority of performance and payment bonds on federal and state construction projects in the United States.

The SAA's Interest in the Funding and Activities of the Small Business Administration – The Surety Bond Guarantee Program.

Some History

Since the early 1970s, the SBA has operated a Surety Bond Guarantee Program ("the Program"). This program which provides surety bond companies with partial repayment of losses from bonds that they would not ordinarily write for less qualified small and emerging contractors. The purpose of the Program is to obtain surety bonds for small and emerging contractors so that they can develop a track record of success. As these contractors grow and establish themselves, they then already have a relationship with a surety company. This surety company then can provide the bonds they need as government contractors, either with or without the SBA Bond Guarantee. The goal of the guarantee program is to graduate contractors into the standard surety market, making the guaranty funds available for new small and emerging contractors.

It is essential to understand why this is important. For most public construction projects, contractors are required to provide surety bonds to the government. These bonds guaranty that the contractor will perform the work and will pay the subcontractors, suppliers and workers on the project. Since the surety will be required to pay if the contractor cannot perform its contract and pay its bills, a surety carefully examines the contractor's capability, experience and financial situation when determining whether or not to put it's own financial wherewithal behind the contractor. Establishing a track record and building capital is a challenge for small and emerging contractors. Therefore, in order to assist these small businesses to obtain work on public projects, the federal government determined that it would act as a reinsurer to sureties willing to write bonds for these contractors.

As the Program has evolved, there are two plans under which sureties can participate in the Program:

The Prior Approval Program ("Plan A") was the original SBA bond guaranty program. In this program, the surety must obtain SBA approval for each bond prior to writing the SBA guaranteed bond. The surety is permitted to charge the rate for the bond that is on file and approved by the state insurance regulator in the state in which the bond is written. The SBA indemnification of the surety in the event of a claim on the bond in Plan A is 80%, and 90% for bonds written for socially and economically disadvantaged contractors and bonds written for contracts under $100,000.

Because of the administrative burden of prior approval, over the years many of the larger, more traditional sureties declined to participate in the Program. Additionally, it appeared over the years that contractors were not graduating out of the Program, but continuing to obtain bonds only with the SBA guarantee. Although there were a significant number of sureties participating, the SBA wanted more of the traditional sureties to participate in the Program. Therefore, the SBA and the industry met to create a program that would be of interest to more sureties. That program is the Preferred Surety Bond Program ("Plan B"). Under this plan, sureties apply to participate, submitting information up front on their underwriting practices, financial strength, etc. Once a surety becomes a participant in Plan B, it is given an aggregate limit of bonds that it can write within the Program. As long as the surety complies with all of the requirements of Plan B, reimbursement of losses is provided without prior approval of the bond.

For Plan B, since it was enacted as a trial program, the SBA limited the rates that the surety could charge to those that the SAA filed. At that time, the SAA was the rating organization for the surety industry. In exchange for the reduction in the administrative burden in Plan B, the surety industry agreed to accept only a 70% indemnification instead of the 80% and 90% provided in Plan A. Since that time, the original regulation has become unworkable. The SAA stopped filing end rates in 1993. However, the SBA never has amended the regulation regarding what the surety should charge for a bond written in Plan B. Unfortunately, this means that current SBA regulations require sureties to charge the end rates that the SAA filed in 1987. Plan B no longer is a trial program, and it needs to be administered accordingly.

The Value of the Program.

In the past ten years, over $8 billion in bonds have been issued to small and emerging contractors through the Program. The Program has provided bonding assistance to small and emerging contractors who might not otherwise be able to obtain bonds. This has been especially true in times of economic downturn when bonding sometimes becomes more scarce and difficult to obtain.

The SBA is permitted to guarantee bonds of up to $2 million. In 2005, Congress increased the maximum bond that the SBA can guarantee to $10 million for any procurement related to Hurricane Katrina. To the SAA, this recent legislation recognizes the requirement and value of surety bonds on federal construction projects. It also shows the desire of Congress that the SBA Bond Program be effective in helping small and emerging contractors, especially now in the Gulf Coast reconstruction.

The Current State of the SBA Bond Guarantee Program.

Over the years, surety participation in the SBA Bond Guarantee Program has ebbed and flowed. One primary driver is the economy, which includes the profitability of the surety industry and the appetite for bonding small and emerging contractors. Another driver, however, is the administration of the Program. In recent years participation in the Program has only decreased, and the reasons for this are listed below in the remedies suggested for the SBA reauthorization legislation and the Fiscal 2007 budget. The fact is that the SBA Program currently is operating at about one-third of its capacity. While this made a great deal of sense in the years when surety was profitable and companies were writing bonds for small and emerging contractors without any need for the Program, it does not make sense now. The economy is such that there is a significant need for the Program. However, internal problems with the Program have discouraged many companies from participating, and discouraged many that do still participate to limit their participation. To make matters worse, it now appears that the Program no longer will even make financial sense to sureties.

In 2005, the SBA finalized changes to its regulations that would implement an increase in the guarantee fee to surety companies from 20% to 32% of the premium on bonds issued and guaranteed under the Program as of April 3, 2006. This fee increase, which amounts to a 60% hike, will likely make the program economically unattractive for most sureties and will affect the continued viability of the program. Sureties already write bonds with very little margin. This reduction in the premium the surety will receive is untenable.

The fee increase apparently resulted from an Office of Management and Budget (OMB) actuarial study of the SBA's losses under the Program, which led to the conclusion that the SBA had to increase the fees charged to sureties in order to cover its losses. Because of the potential impact on surety participation in the Program, the SBA reconsidered its fee increase and recently promulgated a regulation changing the percentage of the premium charged to sureties from 20% to 26%, instead of 32%, and also increasing the fees charged to the small businesses obtaining a bond through the Program. The overall affect of this proposed revision is to increase the SBA's revenues to cover its losses from the Program, by dividing the burden of the increased costs between the sureties and the contractors.

While we appreciate the proposal to reduce the increase, any fee increase on sureties hurts the small and emerging contractors that the SBA is supposed to assist to the extent that it causes sureties to rethink their participation in the program. Without participating sureties, the SBA will not be there to help small and local businesses.

What is Needed in the SBA Reauthorization Legislation and the Fiscal Year 2007 Budget.

The most critical aspect of oversight of the SBA right now is an evaluation of the purpose of the SBA Surety Bond Guarantee Program. The House Committee on Small Business needs to decide if it wants the Program to continue. The SAA is concerned that without

support for the Program at the highest levels, the Program could fade away in the near future.

The SAA believes that the Program is vital to the growth of small and emerging contractors in America. One, well-run Surety Bond Guarantee Program assures consistency of participation requirements and administrative procedures. Without the SBA Bond Program, many federal agencies may initiate their own program to assist small and emerging contractors. Some already have done so. States also have begun this process. Duplicative efforts among federal and state agencies waste time and resources that should instead be used to help small businesses. The SAA urges that the Reauthorization legislation and the fiscal 2007 SBA budget be aimed at increasing the volume of bonds that the SBA Program writes and increasing the number of sureties participating in the Program. We believe that this can be accomplished by the following:

• ***Recognition that the SBA Program Serves an Important Public Policy Function and That It May Not be Self-Sufficient Each Year;*** The SAA understands the strain on the current federal budget due to the enormous unavoidable and necessary expenditures in the Gulf Coast region. However, Congress has never required the SBA Bond Guarantee Program to be self-sufficient. The Congressional declaration of policy for all the SBA programs in the Small Business Investment Act of 1958 was to stimulate and improve the economy by establishing assistance programs for small business which are to be "carried out in such a manner as to insure maximum participation of private financing sources." (15 USC Section 661). If the purpose of the Program is to help small and emerging contractors that may not otherwise qualify for bonds in the marketplace, it stands to reason that there will be losses, and the Program, as originally drafted, acknowledged that fact by recognizing that it could not be self-sufficient. The SAA believes that the OMB's directions to increase fees to cover SBA losses is a major shift in philosophy and direction for the SBA Program and is in conflict with the spirit of the law. The public policy of helping small and emerging contractors is a sound one and it needs to be supported in the funding structure and reauthorization of the SBA.

• ***Transparency in the SBA Fee Structure;*** The basis for the fees charged to sureties participating in the SBA Program should be open and apparent. If the OMB has prepared an actuarial study, this should be made public so that actuaries in the surety industry can review and analyze the data and the conclusions drawn from it. Only then can a meaningful discussion of SBA fees take place. If, for example, more sureties participate and the bond premium volume rises significantly, the current 20% fee will generate more revenue and a fee increase may not be needed.

• ***Elimination of 1987 Rate Requirements*****;** The requirements in the federal regulations imposing price controls on sureties in Plan B of the SBA Program are outdated and must be eliminated. The SAA ceased to make rates in 1993 and has promulgated loss costs ever since. Yet, sureties currently in this program still have to charge the SAA end rate from 1987. The SBA must change this through its regulatory process.

• ***Prevention of the of Unraveling SBA Bond Guarantees;*** A strong deterrent to participation in the SBA Program has been the denial of reimbursement to the surety after a claim has been made on a bond issued through the Program. In the reauthorization

legislation, we would suggest an amendment to the effect that once the SBA has approved a bond in the Prior Approval Plan, it cannot reject the bond after it has been issued, provided that the surety made a reasonable attempt to comply with the law.

• ***Increased Regional Staffing for SBA Bond Program;*** Several SAA members have noted the decrease in the number of SBA regional offices and the overall decrease in staffing in Washington DC and in the regions. We also find that the staff are inexperienced in the surety business such that we would suggest an appropriation for surety bond education and training.

Summary and Conclusion.

The continued viability of the SBA Bond Guarantee Program is at stake at a time when the Program is needed the most. Unprecedented rebuilding needs to take place after the devastation of Hurricanes Katrina and Rita in the Gulf Coast region. Small, local and emerging contractors should have the opportunity to participate in this reconstruction. Bonding will be needed on construction projects in the Gulf Coast states for many years to come. The Program will be a vital part in ensuring that small, local and emerging contractors can obtain the bonds to participate in the reconstruction and go about the business of rebuilding their own companies as well.

To make the Program successful, the House Small Business Committee needs to focus on improvements that are needed, as well as the necessary appropriations. The SBA needs to work immediately to encourage more sureties to participate in the bond program so that it is ready for the upcoming spike in applicants for assistance.

The SBA needs to increase numbers of SBA bond personnel in field offices, provide greater surety education of SBA personnel, and develop a more streamlined application process.

The SAA is willing to provide any assistance in making these changes. We support the continuation and revitalization of the SBA Bond Program. We believe that the SBA and sureties must be business partners in making this Program work.

The current leaders of the Program appear committed to the Program, and have been working hard to revitalize it. However, they cannot do it alone. Congress must be a part of this solution.

Thank you.

CUNA & Affiliates

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WRITTEN STATEMENT
OF
GRACE MAYO
PRESIDENT & CEO
TELESIS COMMUNITY CREDIT UNION
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
BEFORE THE
HOUSE SMALL BUSINESS COMMITTEE'S
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS

MARCH 9, 2006

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MARCH 9, 2006

Chairman Bradley, Ranking Member Millender-McDonald, and other members of the Subcommittee, I am Grace Mayo, President and CEO of Telesis Community Credit Union. I appreciate the opportunity to represent the Credit Union National Association (CUNA) at this hearing to address the Small Business Administration's (SBA) funding level and fee structure for the 7(a) Guaranteed Loan Program, as well as a legislative proposal that would increase credit unions' ability to better serve their members who are small business owners. CUNA is the largest credit union advocacy organization, representing over 90% of our nation's approximately 8,800 state and federal credit unions and their 87 million members.

Telesis Community Credit Union has over $500 million in assets and serves more than 36,000 members. I also serve as Chairperson for Business Partners, LLC, a Credit Union Service Organization (CUSO) that is cooperatively owned by 14 credit unions and serves over 160 credit unions nationwide. Business Partners, LLC was established in 1995 to assist credit unions with member business services and SBA lending programs. The organization serves credit unions that do not have the expertise to offer business loans, providing in-house origination, underwriting, loan participation and quality control services.

CUNA applauds the Chair for holding this important hearing, and looks forward to working with Congress to address the SBA program funding concerns facing today's small business owners and lenders alike.

Credit Union History with SBA's 7(a) Loan Program

CUNA is a strong supporter of the 7(a) loan program, which provides America's small business owners with capital to start or expand their businesses. Previously, the SBA had taken the legal position that credit union participation in the 7(a) program had to be limited to generally those credit unions with common bonds based on geography. As only one in five of the nation's approximate 8,800 federal and state credit unions are

community chartered, this interpretation severely limited the ability of small businesses to obtain SBA-guaranteed loans through a credit union.

On February 14, 2003, the SBA issued a legal opinion removing restrictions on the types of credit unions that may participate as lenders in the 7(a) program. CUNA applauded the SBA and Administrator Hector Barreto for these bold steps. As a result, all types of credit unions that are able to meet the SBA's eligibility requirements are able to participate in the program. Today, as reported by the SBA, over 250 credit unions offer their members SBA 7(a) loans.

While this is very good news for credit unions, it may be even better news for small businesses. As we understand from the SBA, many small businesses have difficulty obtaining funding through banks or other lenders to start or maintain their businesses, particularly when the small business is seeking a loan of less than $100,000. However, given the fact that the average size member business loan is $166,506, while the average credit union SBA member business loan is $94,744, this is a market credit unions are eager to serve.

Credit Union Concerns Regarding SBA's 7(a) Loan Program

CUNA is hopeful that credit union participation in the SBA 7(a) program will continue to grow. Recent research published by the SBA in 2004 reveals that "credit access had been significantly reduced for small businesses," largely in part because of the consolidation in the banking industry. However, credit unions will have a difficult time increasing participation in the 7(a) program faced with the current roadblocks of increased fees and inadequate funding of the SBA's programs.

CUNA strongly supports legislative initiatives to reduce the program's fees and has advocated for the highest possible appropriation in order to keep the program even more beneficial to small business and accessible to credit unions. CUNA believes that the greater the number of available sources of credit to small business, the more likely a small business can secure funding and contribute to the nation's economic livelihood.

Our concerns about the 7(a) program relate mostly to the issue of whether the SBA is sufficiently funded, and the ability for credit unions to continue accessing this program if the fee structure continues to increase. The increasing fees have made the program very expensive for small businesses and lenders, and could have the unintended consequence of blocking credit union access to this program – thus impeding small business access to the smallest of loans.

This year, additional fees have been proposed and existing fees are set to be raised further, making the program even more expensive. The aftermath of Hurricane Katrina is also expected to cause the program's costs to rise in the near future due to an increase in defaults. Additionally, as a result of shifting the full cost to businesses and lenders, the 7(a) program has been destabilized. Without adequate funding, there are only two ways

to manage the program's costs -- either raise fees on businesses or scale back the program.

Let me provide you a couple of examples of the types of SBA 7(a) loans that were issued through Telesis Community Credit Union:

> *One of our credit union members took out a $250,000 SBA 7(a) loan to open a small, non-traditional form of health care business in the southern California. The individual trained in China in traditional Chinese medicine, and was a top student in her class for each of the 5 years spent in medical school winning several awards for her outstanding achievements. Upon graduation, she worked in China for several years as traumatologist, and developed several very effective treatment regimens for afflictions such as musculoskeletal pain syndrome and infertility. She came to the United States and is now currently licensed in California as a Board Certified Acupuncturist. She utilized the proceeds of her SBA guaranteed loan to purchase furniture and fixtures for her clinic, and the machinery and equipment needed to keep the ancient Chinese medicine current and up-to-date in the western technological world.*
>
> *A second example is a $625,000 SBA 7(a) loan our credit union made to a woman who wanted to expand her child care program in Sacramento, California. This woman currently had an established program for two years, however the business struggled with finding adequate facilities to take on additional enrollments to enable the business to gain a stronger financial footing. Due to the tight financial picture, the owner was only able to put down 10% of the purchase price of $525,000 which made her ineligible for most commercial real estate programs (other than the SBA guaranteed 7a program). With their 10% down payment, Telesis Community Credit Union was able to finance the purchase of the real estate for the new facility ($472,500) as well as provide additional funds to purchase furniture and fixtures ($102,500) and supply much needed working capital ($50,000) to aid the business until construction was complete. The original facility could accommodate 54 children; the new facility now houses 110 children.*

Without funding, we will see higher costs imposed on small businesses and a narrower program that does not fully meet the needs of small businesses. Some credit unions are already facing objections from their members to the increased fees for the 7(a) loans. Credit union members used to the reduced fees or free services of their credit union find it difficult to accept a higher fee for a SBA 7(a) loan. Many credit unions, including mine, have been approached by lenders and venture capitalists that are seeking to get referrals of business owners who were interested in, but declined, our SBA lending programs. In some of these cases, these entities have offered lower fees for the business loan, but at much higher rates and/or other loan stipulations that cost much more to the small business owner in the long term.

Going forward, we urge Congress and this Subcommittee to reconsider the importance of the 7(a) program in helping to support small businesses in this country and improve the funding process for this very significant program by pursuing legislation that would reduce the program's fees without affecting the program level and restoring the $80 million appropriation for FY2007.

Need for Reform of Credit Union Member Business Loan (MBL) Limits

A second major roadblock that is threatening credit unions' ability to expand into the SBA 7(a) loan program is the current 12.25% credit union MBL cap. CUNA strongly supports H.R. 2317, the *Credit Union Regulatory Improvements Act* (CURIA) which proposes, among other things, to increase the current 12.25% cap to 20%, and increase the business loan threshold from $50,000 to $100,000. Though the government guaranteed portion of the SBA 7(a) loan is exempt from credit unions' current 12.25% MBL cap, credit unions can only offer SBA loans if they have a formal business lending program. The arbitrary limits that are currently in place greatly restrict many credit unions' ability to offer business loans, and as a result, prohibit credit union access to the SBA 7(a) loan program.

Some mistakenly believe that credit unions first obtained authority to lend to businesses with the passage of the Credit Union Membership Access Act (CUMAA) in 1998. On the contrary, CUMAA imposed statutory limits on credit union member business lending for the first time; until then, NCUA addressed business lending activities of credit unions through supervision and regulation. The CUMAA-imposed limits are expressed as a 1.75 multiple of net worth, but only net worth up to the amount required to be classified as well capitalized (i.e., 7%) can be counted. Therefore, the limit is (1.75 x 7) or 12.25% of assets for most federally insured credit unions.

Credit unions are not major players in business lending, although there are some credit unions which have a field of membership and expertise that would allow them to provide more businesses with more competitive credit options if permitted under the Federal Credit Union Act. (At mid-year 2005, the dollar amount of credit union member business loans was less than one percent of the total commercial loans held by all U.S. depository institutions. Credit union MBLs represent just 3.8% of the total of credit union loans outstanding, and only one in five U.S. credit unions offer MBLs. The average size of credit union MBLs granted in the first six months of 2005 was $166,506.)

Small businesses are the engine of economic growth, accounting for about one-half of private non-farm economic activity in the U.S. annually. Their ability to access capital is paramount. Their access is seriously constrained by the double-whammy of banking industry consolidation and the CUMAA-imposed limitations on credit union MBLs. FDIC statistics show that the largest 100 banking institutions now control over 70% of banking industry assets nationally – in 1992, the 100 largest banks held about 45% of total banking industry assets.

Basic problems with the current MBL limit include the following:

- **The limit is arbitrary and unnecessarily restrictive.** Insured commercial banks have no comparable business lending portfolio concentration limitations. Thrift institutions have portfolio concentration limitations, but those limitations are substantially less restrictive than the limits placed on credit unions in CUMAA. There is no safety and soundness reason that net worth above 7% cannot also support business lending. If all net worth could be counted, the actual limit would average between 18% and 19% of total assets rather than 12.25% of total assets.

- **The 12.25% cap discourages credit unions from entering into business lending.** Even though very few credit unions are approaching the 12.25% ceiling, the very existence of that limitation discourages credit unions from opening business lending departments. Credit unions must meet strict regulatory requirements before implementing an MBL program, including the addition of experienced staff. Many are concerned that the costs of meeting these requirements cannot be recovered with a limit of only 12.25% of assets. For example, in today's market, a typical experienced mid-level commercial loan officer would receive total compensation of approximately $100,000. The substantial costs associated with hiring an experienced lender, combined with funding costs and overhead and startup costs such as a data processing system to support this type of lending, present a serious barrier at most credit unions given the current 12.25% limitation.

- **The MBL threshold definition creates a disincentive that hurts small businesses.** The current $50,000 threshold for defining an MBL is too low and creates a disincentive for credit unions to make loans to smaller businesses. Permitting the threshold to rise to $100,000 would open up a significant source of credit to small businesses. The NCUA Board was on the verge of revising its regulations to move the threshold to $100,000 when Congress incorporated the then $50,000 regulatory definition into the 1998 law. Even business purpose loans up to $100,000 are so small as to be unattractive to many larger commercial lenders. A simple inflation adjustment of the $50,000 threshold, which was initially established by regulation in 1993, would result in a threshold figure of $65,000.

In reforming credit union MBL limits as proposed in H.R. 2317, Congress will help to ensure a greater number of available sources of credit to small business. More credit unions could enter the MBL market, and take advantage of the SBA's 7(a) loan program – which ultimately benefits the small business owner. This will make it easier for small businesses to secure credit at lower prices, in turn making it easier for them to survive and thrive.

Conclusion

In summary, Mr. Chairman, CUNA is grateful to the Subcommittee for holding this important hearing on the funding of key SBA programs. CUNA and our member credit unions look forward to working with the subcommittee to ensure the 7(a) Guaranteed Loan Program operates under a lower fee structure and is properly funded in order to help small business owners gain access to the capital they need to improve their business and our nation's economy.

Name of submitter: Bill Edwards
Title: Executive Director
Organization: Association for Enterprise Opportunity

March 152006

Committee on Small Business
2361 Rayburn House Office Building
United States House of Representatives
Washington, D.C. 20515-6315

Chairman Manzullo, Ranking Member Velazquez and Members of the Committee:

On behalf of the Association for Enterprise Opportunity (AEO) and its 450 member organizations nationwide, we respectfully request that this Committee support these indispensable Small Business Administration (SBA) programs at the following funding levels:

- **Microloan Lending: $25 million in loan authority for lending capital (requiring a $1.8 million appropriation based on current calculations)**
- **Microloan Technical Assistance: $17 million**
- **PRIME: $15 million**
- **Women's Business Centers: $16.5 million**

Thank you for the opportunity to submit comments in connection with the March 15 hearing entitled, "President's Fiscal Year 2007 Budget Request for the Small Business Administration." My name is Bill Edwards, and I am Executive Director of AEO, the national trade and membership association for microenterprise development in the United States. The vast majority of AEO's membership consists of microenterprise practitioner agencies, including over half of all Microloan Intermediaries, PRIME grantees, and Women's Business Centers.

The Administration's proposed termination of the SBA Microloan Program and the Program for Investment in Microentrepreneurs (PRIME) in the FY2007 budget threatens to wipe out two essential federal funding sources for microenterprise development in the United States, effectively terminating the only available sources of business assistance for thousands of underserved entrepreneurs across the country.

The SBA Microloan Program
The SBA Microloan Program, the single largest source of funding for microenterprise development in the nation, was created in 1992 to help small business owners in need of small amounts of capital (less than $35,000) that are not yet "bankable" in the private sector lending community. Since 1992, SBA Microloan Intermediaries have made over 23,000 Microloans totaling over $286 million, primarily to women, minority, and low-income entrepreneurs.

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Different Borrowers

The Administration contends that mainstream private sector banks and the SBA Community Express program are both willing to make loans to traditional Microloan borrowers. This is not true. While banks may at times make business loans under $35,000, the underwriting criteria they employ to justify an extension of capital will most often exclude the average Microloan borrower. The same can be said for the Community Express program, which utilizes much of the same "checklist" type of underwriting procedures. Microloan borrowers often have FICO credit scores as low as 550, past credit problems, little or no collateral, and a lack of business experience. Traditional banks will simply not lend to these borrowers, with or without the benefit of an SBA guarantee program like Community Express. In addition, over 38% of Microloans go to start-up companies.

It is clear that traditional Microloan borrowers have financial needs that are currently not being met by private sector financial institutions or any other federal programs. Nonetheless, the Administration continues to make erroneous statements about how the SBA Microloan Program is duplicative of other existing SBA loan programs. By looking at the demographics of Microloan borrowers, it is evident that this is an underserved population which would not qualify for other SBA loan programs. As such, it is interesting that SBA Administrator Hector Barreto recently testified at a Congressional hearing that the SBA is making a record number and amount of loans, and that Microloan borrowers could also apply for these other SBA loan programs. When asked if he knew the number of Microloan borrowers who would be eligible for these loan programs, Mr. Barreto admitted that he does not know how many of the Microloan borrowers would even be eligible. It is very disconcerting that the Administration is determined to eliminate the SBA Microloan Program, yet admit that they do not know if Microloan borrowers would be eligible to receive loans and business assistance from other federal programs.

A good example of the importance of and critical need for the SBA Microloan Program is Susan Matthews Brown who invented the Boppy, an award-winning nursing and infant support pillow. She credits the non-profit Colorado Enterprise Fund (CEF) for providing the financing her business needed to survive. CEF, an SBA Microloan Intermediary which provides loans to small businesses unable to obtain conventional financing, provided Ms. Brown with her first loan of $25,000 after she was unable to qualify for a traditional bank loan. This loan was used as working capital to finance her appearance at a trade show in Dallas, Texas, which launched her company into the national market after the Boppy won "Best of Show." In a story by CEF she said, "There could be no greater impact on one's business than being the catalyst for its existence. If Colorado Enterprise Fund had not given our company loans when it needed them, it would have gone out of business, and never progressed to the $12 million company it is today." While access to capital is important, technical assistance is also crucial to business success. "Colorado Enterprise Fund may be the only financing available to many, as it was to me. But it plays a bigger role than just that of a lender to a small business. Their staff gives advice, helps establish relationships that can lead to the next stage of financing, and gives encouragement along the emotionally and financially difficult road to building a small business," she said. Susan Matthews Brown's multi-million dollar company now employs 23 people and is just one example of the many entrepreneurs who would not be able to achieve their dream of starting and owning their own business if the SBA Microloan Program was eliminated.

Technical Assistance
The key component of the Microloan Program—and the main reason it has been able to maintain a default rate to SBA of nearly 0%—is intensive pre-and post-loan technical assistance. This technical assistance allows Microloan Intermediaries to extend credit to entrepreneurs with elevated risk profiles, acts as a driver for business successs, and greatly improves the chances for successful business repayment. In contrast, private sector banks typically do not provide any technical assistance to their borrowers. In the case of the Community Express Program, the small amount of technical assistance provided—usually to assist borrowers in completing the loan application—does not compare to the countless hours of Microloan technical assistance provided over the life of the loan. Simply put, the Microloan Program would not work without the technical assistance component. The Administration has maintained that the technical assistance feature makes this program too expensive to continue. In fact, even with the cost of technical assistance, the cost per job created/retained is still much lower than most federal programs.

Geographic Dispersion
Over 38% of all Microloans go to entrepreneurs in rural America. Only a small percentage of Community Express loans under $35,000—in the Microloan range—go to rural America. This is not surprising when one considers that in 30 out of 50 states, the Community Express program has historically made 0 loans or maintained an average loan size above the $35,000 Microloan threshold. Generally, the Community Express program aims for loan amounts that are above the Microloan limit of $35,000 but below $250,000. The Microloan Program, which operates through community based non-profits located across the country, is clearly better suited to provide assistance to local communities in both urban and rural areas.

Cost Effective
Microloan is a cost-effective program that creates and retains jobs that stay in local communities. In FY 2005, the Microloan Program created or retained over 9,800 jobs at a cost per job of roughly $3400 in loan capital—well below SBA's stated goal of creating one job for every $23,000 loaned through the 7(a) program! When technical assistance funds are added, it still works out to only $4900 per job created or retained which is still much less costly than other federal job creation programs. In fact, when compared to the Community Express program in FY 2005, the average cost per job created/retained through the Microloan Program was lower than that of the Community Express Program.

Simply put, the Microloan and Community Express programs clearly serve different borrowers and have different purposes. The Microloan Program targets a unique market of underserved entrepreneurs and operates as a cost effective feeder for private sector banks and government guaranteed lenders. By focusing on capital formation and helping previously "unbankable" small business owners to increase their credit worthiness through small loans and intensive technical assistance, many Microloan borrowers move on to receive larger loans from banks—and even the Community Express Program—as a result of the Microloan Program.

The SBA PRIME Program
PRIME is the only federal microenterprise program that provides intensive training and technical assistance to low- and very low-income entrepreneurs who do not yet seek business capital. For many entrepreneurs, lack of access to capital is only one of the barriers to starting or growing a

successful small business. PRIME provides grants to microenterprise organizations to offer this invaluable assistance. In addition, PRIME is unique in that at least 50% of all grant award dollars must be used to provide these services to very low-income individuals. By providing technical assistance, PRIME enables low-income entrepreneurs to gain fundamental business knowledge that prepares them to seek loan capital later. PRIME serves as the first stop in a continuum that leads to Microloans and then access to financing from traditional commercial banks.

The Administration has proposed the elimination of the PRIME Program for the past six years. However, Congress has continued to fund PRIME each year and in doing so has recognized that by investing in very low-income entrepreneurs, the program succeeds in creating jobs and income in communities that need it most. PRIME is just that—an investment. PRIME clients create and retain jobs, move off of public assistance and pay increased taxes as their businesses and incomes grow. Furthermore, the requested FY 2007 funding level of $15 million could be used to direct a targeted amount of PRIME dollars to assist entrepreneurs in Louisiana, Mississippi, and Alabama. There are not enough large corporations in these states to single-handedly revitalize the local economies which have been devastated by Hurricane Katrina, so small businesses will play a major role in creating jobs and generating taxes to rejuvenate the local economies. With the assistance of PRIME, entrepreneurs can get the intensive business training they need to start their own businesses and contribute to the economic recovery of these Gulf Coast states.

The SBA Women's Business Center Program

The Women's Business Centers (WBC) of the Office of Women's Business Ownership provide training and technical assistance to women starting or expanding their businesses. In 2005 alone, Women's Business Centers across the country trained and counseled over 144,000 women in core business areas such as marketing, bookkeeping and finance. The Centers serve an invaluable role in meeting the special needs of female entrepreneurs across the country.

America's 9.1 million women-owned businesses employ 27.5 million people and contribute $3.6 trillion to the economy. However, women continue to face unique obstacles in the world of business and greatly need the specialized services that Women's Business Centers provide.

Again, the Association for Enterprise Opportunity and its 450 member organizations nationwide respectfully ask that the Committee continue to do what is truly best for small business in America and support these indispensable SBA programs at the following funding levels: $25 million in loan authority for Microloan Lending (requiring a $1.8 million appropriation based on current calculations), $17 million for Microloan Technical Assistance, $15 million for PRIME, and $16.5 million for Women's Business Centers.

Sincerely,

Bill Edwards

Bill Edwards
Executive Director

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Mr. James Hammersley
Acting Assistant Administrator for
Portfolio Management
U.S. Small Business Administration
409 3rd Street, SW
Washington, DC 20416

Subject: RIN3245-AE83

Dear Mr. Hammersley:

The National Association of Government Guaranteed Lenders (NAGGL) appreciates the opportunity to comment on the proposed rule related to *Business Loans and Development Company Loans; Liquidation and Litigation Procedures*.

We believe that many of the provisions of the proposed rule are sound and merely serve to put into regulation existing policies currently contained in SBA's Standard Operating Procedures (SOPs) or notices. However, we have serious concerns about those new or changed provisions that would expand lenders' responsibilities while severely diminishing their rights, impeding their revenue streams and increasing their capital expenditures with respect to the servicing, purchase and liquidation of 7(a) loans. Because of those provisions, after consultation with our membership, we must disagree with SBA's conclusion that the proposed changes will not have a significant economic impact on a substantial number of entities. Our contrary conclusion is that implementation of the proposed regulation will have an adverse impact on every lender, and ultimately on every borrower since the result of such implementation will be a significant contraction of the availability of loans to small businesses, or a significant increase in the costs of such loans, or both.

Feedback from the NAGGL membership indicates that the capital restraints and increased expenses that will result if the proposed regulations are implemented will cause some lenders to drop out of the SBA 7(a) program, and many more to limit their SBA-guaranteed lending. This is especially true for smaller banks and for non-bank lenders, many of which have less access to capital than larger bank lenders. In fact, the existing typical business model for non-bank lenders may not allow them to incorporate the proposed changes. These lenders rely on equity capital and warehouse lines of credit that do not allow loan repurchases to be part of their borrowing base. Therefore, the funds needed to repurchase defaulted SBA-guaranteed loans would have to come out of equity capital and would severely inhibit the lenders' ability to fund new loans.

Based on comments received from NAGGL members, we must conclude that implementation of the proposed regulation would likely have a chilling effect on the secondary market for both bank and non-bank lenders, thereby diminishing this source of

capital to fund small business loans. Under the regulation, as proposed, in order to maintain any role in the decision-making process, a lender would essentially be required to repurchase from the secondary market any defaulted loan. If this were to happen on a regular basis, it would likely jeopardize lenders' ability to get sales treatment for such loans. This would have an immediate and significant adverse impact on the lenders' capitalization structures.

The requirement that lenders fully liquidate their loans before requesting purchase from SBA could also serve to lessen recoveries on defaulted loans since lenders would have an incentive to choose the most expedient commercially reasonable liquidation activities, rather than those likely to provide the greatest recoveries to the lenders/SBA. This proposed requirement would also discourage lenders from attempting to enter into "work-out" arrangements even when there is a likelihood of business recovery. This, too, would have the unintended consequence of potentially reducing loan recoveries, and would also not be in the best interests of borrowers experience difficult, but not necessarily fatal, business set backs.

For the reasons noted, NAGGL strongly believes that implementation of the regulation, as proposed, would not be in the best interests of the government, potential small business borrowers, or the lending industry.

NAGGL's section-by section analysis of the proposed regulatory changes follows.

Sections 120.10 – "Definitions" and Section 120.180 – "Lender and CDC Compliance with Loan Program Requirements

NAGGL opposes the proposed amendments to these sections. We are concerned that if these provisions take effect, a lender would have no way of knowing at the time it makes a loan what its ultimate responsibilities would be with respect to servicing and liquidating the loan. Since SBA has absolute unilateral authority to issue SOP changes and notices, a lender would, in effect, be agreeing in advance to be bound by policy and procedural changes that could actually conflict with or violate the institution's internal policies and requirements. The Agency's unilateral authority to issue SOPs and notices would also mean that a lender would have no opportunity to comment, in advance of implementation, on proposed changes that could adversely impact its participation with SBA. Therefore, a lender would have no way of estimating, in advance of seeking an SBA guaranty, the total cost of complying with SBA program requirements throughout the life of the loan, and the ultimate cost-effectiveness of such participation.

We must note, too, that SBA has a long history of failing to timely update its SOPs; failing to timely incorporate into the SOPs, policy and procedural changes that are made effective by publication of notices; and, failing to extend the effective dates of its notices so that the program is frequently operating under policies mandated by expired notices. Given these circumstances, it would be difficult for lenders to be certain of the program requirements in effect when it decides to take a particular action. And, merely noting that

SOPs are available to the public on the SBA Web site would not appear to adequately overcome this concern.

We also question the enforceability of directives contained in the SOP and notices. We are aware that the courts have historically upheld the enforceability of SBA's statutory mandates, and, we believe, regulatory requirements. However, we do not believe that the courts have consistently upheld the enforceability of requirements contained only in the Agency's SOPs and notices. Therefore, we do not believe that lenders can or should be made subject to adherence to this third group of program requirements. Also, we are not convinced that the requirement that a lender comply with after-the-fact changes to loan program requirements is enforceable if challenged in the courts where, we believe such practices have been frowned upon.

Section 120.181 – *Status of Lenders and CDCs*
NAGGL has no objection to this section.

New Section 120.197 *Notifying SBA's Office of Inspector General of suspected fraud*
NAGGL strongly supports the mission of SBA's Office of the Inspector General to curtail fraud, waste and abuse within the SBA and its programs; and NAGGL believes that individual lenders and loan recipients are responsible for supporting this critically important mission. However, we oppose the new section as drafted. First, we believe that this proposed section is unenforceable because of its vagueness (e.g., its failure to fully define the parties to which it applies – the "others" category – or to specify what, if any, penalties would be imposed for non-compliance). We also oppose this section, as drafted, because we believe that it could allow what would amount to a second-guessing of what information a lender or borrower had, and when, and whether the information rose to the level of "indicating that fraud may have occurred." This could lead to the Agency's attempt to reduce or deny its liability on an individual loan based on an OIG determination that a lender had failed to comply with this referral provision. Finally, we believe that the appropriate point of contact between lenders and borrowers and SBA is the Office of Capital Access. Therefore, NAGGL recommends that referrals of potential fraud be directed first to that office which will then have responsibility for further referring the matter to OIG, if deemed appropriate.

NAGGL would consider supporting the inclusion of this section with language similar to the following:

> It is the role of the SBA Office of Inspector General to protect against fraud, waste and abuse in the Agency's programs. SBA expects its program partners, including lenders and CDCs, and its borrowers, to strongly support this important mission. Therefore, whenever any party to an SBA loan obtains factual information

causing a reasonable belief that fraud has occurred in connection with the loan, that party should immediately report the suspected fraud to the Office of Capital Access, U.S. Small Business Administration, 409 3rd Street SW, Washington, DC 20416.

Section 120.440 – *The Certified Lenders Program*
NAGGL imposes no objection on this section.

Section 120.453 – *Responsibilities of PLP Lenders for servicing and liquidating 7(a) loans*
NAGGL imposes no objection on this section.

Sections 120.500 – *(Loan Administration) General*, 120.510 – *Servicing direct and immediate participation loans*, 120.511 – *Servicing guaranteed loans*, 120.512 – *Who services the loan after SBA honors its guarantee?*, and 120.513 – *What servicing actions require the prior written consent of SBA ?*
NAGGL does not object to the proposed administrative changes.

Section 120.520 – *Purchase of 7(a) Loan Guarantees*
NAGGL opposes the proposed changes to Section 120.520(a) which would take away the current right of a lender to request that SBA honor its guarantee if the borrower is in default on any installment for more than 60 calendar days (or less if SBA agrees); and would mandate that for any loan approved on or after the effective date of the proposed regulation, and not sold in the secondary market, that the lender not be able to make demand on SBA to purchase its guaranteed portion of the loan until the lender has completed liquidation activities, except when collection of the loan involves a judicial or other similar proceeding that has been underway for more than 18 months.

These changes would have an adverse impact on the cash flow of a lender that has a loan default because the lender would have to wait for what may be an extended period of time to receive SBA's reimbursement for its guaranteed share of the loan – up to 18 months in cases involving protracted litigation. NAGGL also believes that implementation of this proposed provision would also have an adverse impact on the monetary recoveries on SBA-guaranteed loans, and consequently on the program's subsidy rate since a lender would be apt to choose the most expedient commercially reasonable liquidation action rather than the one most likely to garner the greatest recovery to the lender/SBA.

As noted in our introductory general comments, we also oppose this section's de facto requirement that lenders repurchase from the secondary market their defaulted loans if they wish to maintain any role in the decision-making process for subsequent liquidation

and asset sale actions. As previously stated, comments received from NAGGL members indicate that implementation of the proposed regulation which would put lenders in the position of having to repurchase loans from the secondary market could jeopardize lenders' ability to get sales treatment for such loans. This would have an immediate and significant adverse impact on the lenders' capitalization structures, and would have a chilling effect on the secondary market. This, in turn, would greatly lessen the availability of borrower capital for small businesses.

With regard to the provision that would require a lender to provide "sufficient" documentation for SBA to review the lender's administration of the loan, we would also object because the proposed language is somewhat vague in that it does not specify exactly what documents will be required. Therefore, we recommend that the proposed regulations be revised to state that the minimum documentation required for purchase will be fully described in the Agency's SOP(s).

Section 120.522 – *Payment of accrued interest to the Lender or Registered Holder when SBA purchases the guaranteed portion*
NAGGL opposes the proposed changes because we believe that, coupled with the requirement that a lender fully liquidate a loan before requesting that SBA honor its guaranty, these changes would have an adverse impact on the cash flow of a lender that has a loan default. We also believe that implementation of this proposed provision would have an adverse impact on the monetary recoveries on SBA-guaranteed loans, and consequently on the program's subsidy rate since a lender would be apt to choose the most expedient commercially reasonable liquidation action rather than the one most likely to garner the greatest recovery to the lender/SBA. For these reasons, we recommend that the proposed regulation be amended to provide a waiver of the interest payment limitation when warranted by the circumstances of the individual case.

Section 120.524 – *When is SBA released from liability on its guarantee on loans?*
NAGGL generally opposes the proposed changes to this section. However, it concurs with the proposed changes to Section 120.524(a)(8).

As to the proposed amendment to Section 120.525(a)(1), SBA has a long history of failing to update its SOPs, and of failing to incorporate into the SOPs policy and procedural changes that are made effective by publication of notices. We therefore believe it will be difficult for lenders to be certain of the program requirements in effect when it decides to take a particular action.

NAGGL also opposes the proposed changes to Sections 120.525(b), (c) and (d) because they represent a general broadening of the documents and sources of information that SBA will consider in determining whether to honor its guarantee of an individual loan, as well as a virtually infinite extension of the period of time allowed for SBA to reconsider

its decision to honor a particular guarantee and seek to recover funds paid to the lender. This later provision could wreck havoc on lenders' reserves since they would never know when SBA might seek recoveries on loans considered to have been finally resolved. As to this provision, NAGGL recommends that the regulations be amended to fix the period of time during which SBA could seek recovery from a lender, and notes that fixing this period at seven years would be consistent with the statute of limitations governing most criminal and civil actions.

NEW Section 120.535 – *Standards for Lender and CDC loan servicing, loan liquidation and debt collection litigation*
NAGGL has no objection to this proposed new section except to note its previously stated concerns about utilization of the proposed new definition for *Loan Program Requirements*

NEW Section 120.536 – *Servicing and liquidation actions that require the prior written consent of SBA*
Except as noted, NAGGL finds the proposed amendment to be consistent with existing policy and supports the proposed limitations on the actions that require SBA prior approval and the requirement for documenting loan files as protecting the interests of both the lender and SBA. NAGGL would reiterate, however, its concerns about utilization of the proposed new definition for *Loan Program Requirements.*

NEW Section 120.540 – *Liquidation and litigation plans*
Under this proposed revision, SBA's prior approval of 7(a) loan liquidation plans would be required only for CLP loans – as mandated by statute. NAGGL supports this proposed change. We oppose, however, the portions of the section relating to litigation plans that would essentially put into regulation existing Agency requirements relative to such activities. NAGGL believes that the narrow strictures being placed on lenders with regard to conducting litigation activities is at odds with the Agency's general policy of delegating virtually all other servicing and liquidation activities to lenders. We also believe that in a time of shrinking Agency personnel and other resources, the imposition of these restrictions could significantly lengthen the time taken to achieve the orderly collection of outstanding loan obligations. This position is supported by anecdotal information provided from NAGGL members indicating that lenders frequently experience long delays in obtaining approval from SBA for those actions requiring such approval, especially those actions requiring decisions from SBA's field or headquarters counsel.

If this section is implemented NAGGL supports the concept of raising the dollar threshold distinguishing between routine and non-routine litigation from $5,000, to a higher amount, but would recommend that that amount be increased to $25,000 to allow lenders greater flexibility to conduct routine litigation without SBA's prior approval.

New Section 120.541 – *Time for approval by SBA*
NAGGL has no objection to the provisions of this section that would implement existing statutory mandates regarding approval of liquidation plans for CLP loans. However, it objects to those provisions of this section that would give SBA virtually unlimited time to approve or deny proposed litigation plans, particularly since, under other proposed regulatory changes, lenders would be required to defer purchase of defaulted loans until all liquidation activities had been completed. NAGGL would concur with the 15-day response period subject to an additional requirement allowing a lender to presume approval of its plan if the Agency does not respond within 20 business days of the lender's submission of the plan, or if the Agency does not meet its projected extended date for such response. In imposing this objection, NAGGL notes that because of shrinking Agency personnel and other resources, the imposition of these restrictions could significantly lengthen the time taken to achieve the orderly collection of outstanding loans.

NEW Section 120.542 – *Payment by SBA of legal fees and other expenses*
Except with regard to new Section 120.542(b), NAGGL imposes no objection to this section. NAGGL opposes Section 120.542(b)(1) which specifies that one of the circumstances under which SBA, in its discretion, may decline to pay for costs incurred in connection with the liquidation or litigation of a loan would be SBA's determination that the lender did not act promptly and in accordance with commercially reasonable standards, or did not comply with SBA *Loan Program Requirements*, etc. NAGGL believes that this provision is too vague to be reasonably interpreted by lenders or SBA, and again notes its objection to the requirement for adherence to the proposed newly defined *Loan program Requirements*.

Section 120.546 *Loan asset sales*
NAGGL opposes this proposed change that would essentially provide to SBA sole authority to sell in an asset sale any loan made on or after the effective date of the regulations if liquidation has not been concluded by the lender. This provision would, in effect, require a lender to purchase the guaranteed portion of a loan sold in the secondary market from the registered holder, rather than allowing SBA to do so, in order for the lender to protect its interests in the loan. As previously noted, this requirement could jeopardize a lender's ability to get sales treatment for its loans sold into the secondary market, thus severely impacting its capitalization structure.

Similarly, in a circumstance where SBA has honored its guaranty prior to the conclusion of liquidation activities, SBA also would have sole authority to make an asset sales decision – and it is such a case that would most likely be the most contentious as between SBA and the lender because, in order for SBA to have purchased the loan prior to

liquidation by the lender, there must have been a decision that the lender was not fulfilling its responsibilities or that a potential conflict of interest existed between SBA and the lender. So, especially in such circumstance, NAGGL believes that SBA should offer the lender the opportunity to participate as a full partner in any decision to proceed with including the loan in an asset sale, rather than obtaining recovery through more traditional methods. Asset sales should be regarded as one tool for collecting all, or a portion of, the SBA/lender debt. But, given a lender's interest in assuring maximum recovery, a lender should always be allowed to participate in the decision whether a loan will be sold through an asset sale.

However, recognizing SBA's need to achieve ultimate efficiency in its asset sales process, and knowing that protracted attempts to obtain lender approval for such sales, NAGGL would consider supporting a provision that would require each lender to provide to SBA an address where any requests for consent to an asset sale should be sent, and then allow a SBA to presume lender consent if notice is properly sent to such address and no response is received in a reasonable period of time, e.g., 60 days.

NAGGL offers no comments on the remaining sections of the proposed regulation that deals with requirements related only to the 504 loan program.

Again, thank you for providing the opportunity for NAGGL to comment on these critically important proposed regulations. While NAGGL has objected to many of the proposals, we share the Agency's desire to streamline the liquidation and litigation process. NAGGL stands ready to work with the Agency to develop liquidation and litigation procedures that are mutually beneficial and workable for the Agency and your lending partners.

Respectfully,

Anthony R. Wilkinson
President & CEO