NADCO
National Association of Development Companies

National Association of Development Companies (NADCO) Statement for the Record

Oversight of the Small Business Administration

House Committee on Small Business
March 23, 2023

The National Association of Development Companies (NADCO) represents the Certified Development Company (CDC) industry whose economic development mission is realized through delivery of the Small Business Administration's (SBA's) 504 Loan Program, Community Advantage Loan Program (CA), Microloan Program, and a myriad of other federal, state, and local programs.

NADCO shares the CDC industry perspective and support for the SBA's proposed rule titled, "Affiliation and Lending Criteria for the SBA Business Loan Programs," released on October 26, 2022. The proposed rule streamlines SBA's current lending criteria from nine metrics to three, incorporates the use of credit scoring in the underwriting process, and simplifies affiliation principles to ease understanding and compliance by lenders and borrowers. To provide further detail outlining our support for these proposed rule changes (with noted caveats), NADCO offers the following commentary:

1. NADCO supported SBA's streamlining of lending requirements for the Community Advantage Loan Program in April 2022 and supports extending the simplification and modernization of its lending requirements to the 504 Loan Program, while also embracing new technology to allow generally acceptable commercial credit analysis processes and procedures, including loan scoring models, to streamline underwriting. However, we also strongly encourage SBA to continue its focus on prudent lending standards while balancing program access with portfolio performance and program integrity.

2. For 504 Loan Program purposes, NADCO specifically supports SBA removing the requirement to consider character and reputation because as SBA stated in the proposed rule, "the lending industry commonly uses the terms character and credit history interchangeably." Credit history is a more objective, empirical measure than the amorphous concepts of "character" and "reputation." SBA's proposed change would focus more appropriately on current conditions more indicative of creditworthiness rather than minor infractions in an applicant's past.

3. There are a few caveats to NADCO's support for the proposed changes to lending criteria. First is the concern that SBA may implement a minimum credit score for all loans – we recommend SBA make clear in SOP guidance that CDCs are able to use mitigating factors when a credit score is impaired for explainable reasons. NADCO also recommends that SBA retain the consideration of "experience and depth of management" in its lending criteria, as this is particularly important for start-up or new businesses –

while management strength can be implied by the financial performance of existing businesses, it should be a separate consideration for start-up or new businesses where underwriting is based in part on management skills and projections.

SBA's proposed rule also seeks to streamline SBA's affiliation criteria for its business loan programs, including 504. SBA proposes to specifically remove the principle of control of one entity over another as a separate basis for finding affiliation because the concept of control has proven particularly burdensome for applicants and lenders to understand and implement. The current level of complexity has led to inconsistent interpretation and implementation by all parties in the loan approval process. SBA's proposal would create a "bright line" test that CDCs and small businesses can easily understand and implement.

Program simplification that makes it easier for borrowers, CDCs, and SBA has long been a pillar of NADCO's advocacy with SBA and Congress with the belief that the modernizing and streamlining impact of this rule will be felt most by borrowers. A more efficient 504 program means more time for borrowers to focus on their business growth and in a fluctuating interest rate environment, it means more savings since the 504 borrower's interest rate is set for the life of the loan at the time of funding, not application. This is the real-world impact we expect to see as a result of these changes, all while CDCs and banking partners continue due diligence and SBA continues rigorous oversight of CDCs to ensure compliance with SBA requirements.

Of note, the affiliation changes made in this rule do not supersede the underlying SBA monetary parameters for loan eligibility of $15 million net worth and $5 million net income, SBA industry-based size standards, and the SBA requirement that any individual or entity who holds 20 percent ownership of the applicant business must be a guarantor on the loan, which identifies affiliated businesses (including a six-month "look back" to capture changes of ownership and ensure all required owners are guarantors on the loan).[1]

With respect to the individual revisions to affiliation principles –

1. NADCO supports SBA's proposed revisions to affiliation based on ownership **(removing principal of control)**. The underlying parameter of guarantors, including any individual or entity with 20 percent ownership, remains in place. The rule also includes a NAICS code determination of affiliation, which will augment the 20 percent rule.

2. NADCO supports SBA's proposed revisions to affiliation based on stock options, convertible securities, and agreements to merge **(removing principal of control)**. The 20 percent ownership rule would also apply to this affiliation determinant; these items will have a present effect on ownership of the entity.

3. NADCO supports SBA's proposed elimination of affiliation based on management. NADCO also supports SBA's statement that "it [SBA] should not interfere in a business owner's right to enter into a service agreement with a management company." To the extent that SBA requires review and approval of management agreements for loan program requirements (i.e., passive business

[1] SOP 50 10 6

activity), NADCO expects SBA will continue its current guidance established in existing Standard Operating Procedures (SOP).

4. NADCO supports SBA's proposed elimination of affiliation based on identity of interest. NADCO agrees with SBA that the existing requirement is "inherently unfair and impractical" when a close relative is not a principal of the applicant business. This affiliation determinant is cumbersome, inconsistently applied, while offering no measurable risk mitigation.

5. NADCO supports SBA's proposed elimination of affiliation based on franchise and license agreement; however, NADCO does not support elimination of the SBA Franchise Directory if SBA intends to shift franchise business model eligibility determinations to the CDC that are beyond the scope of current SOP guidance on ineligible business types. To the extent that any additional burden will be shifted to the CDC, keeping SBA involvement will assure consistency, avoid second guessing through SBA's oversight activities, and provide transparent assurance to CDCs, third party lenders, and small business applicants.

NADCO appreciates the opportunity to share the CDC industry perspective and support for the SBA's "Affiliation and Lending Criteria for the SBA Business Loan Programs" proposed rule and we look forward to working with Chairman Williams, Ranking Member Velázquez, and members of the Committee to improve access to capital to small businesses nationwide.

Sincerely,

Rhonda D Pointon

Rhonda Pointon
President & CEO
National Association of Development Companies (NADCO)