



**NATIONAL ASSOCIATION**  
OF GOVERNMENT GUARANTEED LENDERS

**“Taking on More Risk: Examining the SBA’s Changes to the 7(a)  
Lending Program Part II”**

**Testimony before the House Committee on Small Business**

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**Submitted by**

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Chairman Williams, Ranking Member Velázquez, and Members of the Committee— my name is Tony Wilkinson and I have served as the CEO and President of the National Association of Government Guaranteed Lenders (NAGGL) since December 1987. NAGGL is a national trade association of approximately 1,000 banks, credit unions, non-depository lenders, mission lenders, CDFIs, and other entities that participate in the Small Business Administration’s 7(a) loan guarantee program—NAGGL represents all types of lenders. And our lender members are responsible for at least 80% of the total 7(a) loans made each year.

I want to thank both this Committee and its Senate counterpart for the thoughtful consideration that each is giving to the sweeping changes that the Small Business Administration is currently implementing for its loan programs and the grave dangers that these changes pose to the 7(a) program, the millions of small businesses supported by 7(a) loans, and to the American taxpayer. I am grateful to be able to add my thoughts to that consideration.

On behalf of NAGGL’s members, I want to assure you that we strongly support the stated intention of the 7(a) program changes – increasing access to capital for America’s small businesses, especially those in underserved markets and those needing smaller loans, and streamlining program processes. Unfortunately, however, we do not believe that the changes being implemented will achieve those goals, and, in fact, we have serious concerns that they actually may undermine the integrity of the program.

And let me say upfront that our concerns are not rooted in any desire to protect current lenders from additional competition or to bar different types of lenders from joining the program. Rather, our concerns remain consistent with those that we stated in our public comment letters when the rule-changes were originally proposed – that the changes will threaten programmatic integrity and potentially harm the most vulnerable small business borrowers. We will provide those letters for the hearing record.

As a result of changes made in the two Final Rules that took effect last week, SBA is both removing the long-standing guardrails that have assured prudent lending in the 7(a) program and, at the same time, opening the program to additional non-federally regulated lenders. In my 40-year career in this program, I have never seen such sweeping changes that provide more of a recipe for disaster.

And, although we still are digesting the additional changes that SBA continues to make through piecemeal program notices and a new standard operating procedures manual (SOP) slated to take effect on August 1, it is already clear that the guidance provided in those documents will only serve to exacerbate our original concerns.

When considered in their entirety, it becomes apparent that SBA’s regulatory and policy changes will likely lead to higher losses in the program, leading to increased program costs. This domino effect would result in increasing the cost of access to capital for the very borrowers we all seek to aid. NAGGL’s decades of experience in this program tells us that SBA’s recent changes need to be reconsidered and that a different approach is needed – one that better balances the risks and rewards that will come with this sweeping redesign of the 7(a) program.

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*The Overview: Loosening Prudent Lending Guardrails Simultaneously with Opening the Program to an Unlimited Number of Non-Federally Regulated Lenders Without Providing Adequate Oversight*

SBA's historic and sweeping changes to morph the 7(a) Loan Program from its previous prudent lending structure and usher in an unlimited number of non-federally regulated lenders comes from two new rules: *Affiliation and Lender Criteria for the SBA Business Loan Programs* (87 FR 64724) ("Affiliation Rule") and *Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization* (88 FR 21890) ("SBLC Rule"). Individually, each of these rules is concerning. But when taken together, the concerns are multiplied.

As noted, any analysis of the rules must include an understanding of the further changes to the 7(a) program included in the newly issued notices and SOP 50 10 7, which provide more detailed guidance regarding how the program changes will be implemented by SBA and by 7(a) lenders.

First, the Affiliation Rule removes from SBA's regulatory framework the consistent, well-established underwriting guidelines all 7(a) lenders have been required to follow for years and now allows lenders to follow the same processes and procedures that they use for their similarly-sized non-SBA guaranteed commercial loans. In calls that SBA hosted for lenders and in several recent presentations made to lenders, SBA itself has described this policy as telling lenders to "do what you do".

This is not streamlining. This is wholesale removal of the guidelines that have served this program well for decades and have ensured that both lender behavior and portfolio performance stays at an acceptable level. Every principle included in the now-deleted list of underwriting criteria was put there to address a specific concern or in response to a past lender behavior that both the industry and the SBA believed needed to be corrected. I believe that removing these guardrails could create a race to the bottom in terms of the conditions that individual lenders will impose on individual loans.

Congress, particularly this Committee, has a vested interest in assuring that there are prudent lending standards clearly spelled out. I know that Congress expects that lenders will be good stewards of a program that offers the backing of the federal government for up to 75, 85 or even 90 percent of any defaulted loan (with the guaranty percentage depending on loan size and whether the loan supports international trade). The current 7(a) loan portfolio includes nearly \$107 billion in outstanding principal loan balances, with the government being liable for approximately 75 percent of that amount.

And here it is important to remember that the performance of a federally-guaranteed loan program is critical to both mitigating taxpayer risk and keeping access to the program affordable for small business borrowers. Currently, the low loss rates in the 7(a) loan program assure that the fees from lenders and borrowers are sufficient to cover the estimated cost of making loans

each Fiscal Year (FY) (the “subsidy rate”). In other words, the current performance of loans made through the 7(a) program does not require Congressional appropriation or taxpayer dollars.

However, if losses increase, then the estimated costs of making 7(a) loans will also increase. This domino effect will not happen right away. Typically, losses occur three to five years after the loan has been originated. And these increased costs would have to be covered by either Congress passing legislation to statutorily increase the maximum fee limitations on small business borrowers and lenders, or by an appropriation of taxpayer dollars. Either option is an undesirable outcome. But if estimated loan costs go up to the point where existing fees no longer cover the costs, unless one of those solutions were to be provided, the 7(a) Loan Program would shut down without a means to cover anticipated program costs by virtue of the Anti-Deficiency Act.

SBA is creating a bare-minimum approach to lending standards, thus increasing risk tolerance which will increase losses. So, unless the Agency takes steps to address these issues or Congress addresses these changes in legislation, then in a few years, when the predicted loan losses have materialized, Congress, SBA, and the industry will be looking for a way to prevent a 7(a) program shutdown.

And it is into this new environment where lenders generally are now permitted to do whatever they believe is prudent that SBA, through the SBLC Rule, is simultaneously lifting the existing forty-year moratorium to license additional non-federally regulated lenders (Small Business Lending Companies or “SBLCs”) to make 7(a) loans. This follows more than four decades of SBA having capped the number of SBLCs at 14 licenses because of its own concerns about the agency’s ability to serve as the primary regulator for otherwise non-federally regulated entities. In fact, as recently as January 2021 as part of another rulemaking, SBA indicated that increasing the number of SBLC licenses would exceed its oversight capabilities and pose unacceptable risk to the Agency. Now, in a complete reversal without any evidence of changed capacity, SBA has finalized rules that will allow a potentially unlimited number of additional non-federally regulated lenders into the 7(a) program. In the background information to the rules, SBA stated that it believes it has the capacity to add three additional licenses *now*, but the actual regulatory language is silent as to the number of licenses that ultimately can be issued. SBA has cleared the way to admit any number of SBLCs in the future – not the “slow and steady” approach that has been described.

Here is the real merging of the consequences of the Final Rules: SBA is bringing in non-federally regulated lenders on an unlimited basis into a now seriously morphed program where most of the basic guardrails have been removed, telling these new non-federally regulated lenders to do what *they* think is best.

When a lender is directed simply to follow procedures it would use for its similarly sized non-SBA-guaranteed commercial loans, the likely result is that federally regulated lenders will continue to operate based on the requirements imposed on them by their primary federal regulators, while non-federally regulated lenders will not have such limitations. Therefore, for non-federally regulated lenders making 7(a) loans, there is now a very different and loosened set of criteria, and their new primary regulator, SBA, is saying do whatever you think is prudent.

SBA has indicated that it will review a new entrant's lending policy when it applies for a SBLC license in order to ensure that the new SBLC will be making loans prudently. But we have yet to see what licensing criteria SBA will establish to govern the selection process. And what will really matter is whether SBA will have the resources and the capacity to closely monitor the lenders for which it is the primary regulator and to enforce corrective actions when deemed necessary and appropriate. This will require more than just reviewing an up-front policy in a SBLC's application or even looking at a sample of loans every other year, as the current SBLC exam process generally requires. And because this will exceed SBA's current oversight structure and capacity, it appears that there is a great likelihood for a starkly uneven playing field between federally regulated and non-federally regulated entities participating as 7(a) lenders. The result will be a lack of consistency in how the program is delivered, which can impact both program integrity and the way different borrowers are assisted through the program.

To put this into perspective it is important to remember that SBA currently serves as the primary regulator for 14 "regular" SBLCs and slightly more than 100 Community Advantage (CA) Pilot Program lenders, a mission-based lending subset of the 7(a) loan program that has existed since 2011. SBA also is the primary regulator for another approximately 270 Certified Development Companies (CDCs) that deliver the Agency's 504 loan program, some of which are also CA lenders. However, despite this set of oversight responsibilities, the Agency really has never been equipped to be a primary regulator. This deficiency has been somewhat mitigated by the fact that SBA only serves as the primary regulator for this relatively limited group, with most of these lenders previously operating under fairly restrictive guidelines before these recent rule changes.

Opening the door for an unlimited number of lenders supervised only by SBA will change this dynamic in a number of ways. First, the SBLC Rule makes a very significant change by allowing the regular SBLCs, including those that will be new to the program, to now be able to have other lines of business besides making 7(a) lending and making loans to microloan intermediaries, a lifting of an important guardrail. The final SBLC Rule made this change although this concept had not been mentioned in the SBLC Proposed Rule. SBLCs making non-SBA loans has never been permitted before because, presumably, it requires SBA to now provide oversight for more than just 7(a) lending if SBA is going to be a primary regulator of these entities. As a primary regulator, SBA would need and want to ensure the lender is properly monitored in all its lines of business to ensure safety and soundness of the 7(a) loans generated by that lender. SBA does not have this kind of oversight capacity, yet these changes would necessitate it. Most concerning to me is that SBA has not addressed this additional burden, nor is there an existing framework for SBA to perform such regulatory functions.

In addition to adding more regular SBLCs to the program which we already have discussed, the SBLC Rule adds a new category of SBLCs, which the Final Rule calls Community Advantage (CA) SBLCs, a change from the designation of Mission-Based SBLCs that was in the Proposed Rule. While a recent notice limits CA SBLCs to making loans of \$350,000 and less and continues to require that 60 percent of their loans go to borrowers in underserved markets, which we will discuss in greater detail later, those restrictions do not appear in the regulatory text. So, it is difficult to know how much any future program changes could increase the burden on SBA to oversee these lenders. Also, given the way that the 7(a) program requirements have been changed, we expect that the new regular SBLCs most likely will be lenders that, following their

current business practices, rely on algorithms and automation to generate a high volume of loans. So, it is difficult to know whether SBA's estimate in the regulations that the three new SBLCs will only add 425 loans per year for the first four years will actually hold up, or whether that loan volume could be significantly higher – thus increasing the oversight burden on SBA.

More loans for more small businesses is a good thing—but not when SBA has just said to all lenders “do what you do” and lacks the resources to properly oversee the activities of the lenders that it regulates. SBA does not have the resources, the capacity, or even an existing regulatory framework to serve as a prudential regulator for an unlimited number of Fintech entities.

This concern over SBA's oversight capacity is specifically identified in a March 21, 2023 white paper, “*7(a) Loan Program During SBA's Response to the COVID-19 Pandemic.*” While focused on assessing SBA's response during the pandemic as it relates to its management of the 7(a) program and its portfolio, the report offers an invaluable insight into the state of SBA's Office of Credit Risk Management (OCRM) which is responsible for SBA oversight functions. The report states that OCRM is significantly understaffed, and that as of August 24, 2022, OCRM “staffing levels decreased from 42 to 26 employees,” a decline of 38%. As a result of a shortage of oversight staff and resources, the OIG notes that OCRM has shifted to “streamlined lender reviews instead of full scope reviews.” The report goes on to note the deficiencies in these streamlined reviews given that they are limited and data-driven and do not include an assessment of loan files or have the full comprehensive review components of full scope reviews. In FYs 2015 to 2017, the OIG notes that OCRM did not conduct over 30% of its planned reviews of high-risk lenders and raises concerns that current oversight goals may not be met given the current shortage of oversight staff.

Here it is important to note the contrast between the way the OIG report depicts OCRM's resources and the way that the SBLC Rule depicts OCRM's capacity. On the one hand, the OIG notes significant staffing shortages and issues with the current oversight burden. On the other hand, SBA asserts that OCRM is fully able to take on the significant new oversight responsibilities that lifting the SBLC moratorium will bring.

OCRM resources have also been an ongoing concern. For every fiscal year since 2014, there has been a \$12 million set-aside out of SBA's annual Salaries & Expenses account from Congressional appropriations mandated to go toward “oversight activities.” But, during the period that this amount has remained unchanged, the overall 7(a) Loan Program's authorization cap has nearly doubled, and OCRM has added PPP and other responsibilities to its oversight mandate. And, as we understand it, the oversight carve-out is not distributed solely to OCRM at its discretion—rather, it appears to also be distributed to the other divisions within SBA that provide some form of administrative or other support of the OCRM function, e.g., the offices of general counsel, information technology, financial operations, etc. It is hard to understand how SBA, in proposing these sweeping changes, would fail to even include in its President's Budget Request or in any other context, a request for additional resources.

However, additional funding still would not overcome the major concern that arises from the fact that SBA has always relied upon the vast majority of its lenders having a primary federal regulator and so has never attempted to create a similar framework for the lenders for which it

serves as primary regulator. This leaves SBA without a wholistic structure necessary for it to act as the primary regulator for additional lenders and to conduct the necessary compliance and risk assessment at the institutional level.

NAGGL also continues to have concerns regarding whether the lenders for which SBA serves as the primary regulator are monitored by SBA for compliance with Bank Secrecy Act/Know your Customer/Anti Money Laundering standards. In its letter to the Senate Small Business Committee dated March 20, SBA states that “All 7(a) lenders, including SBLCs, are required to comply with the named requirements and that SBLCs are also responsible for and evaluated on compliance with: Truth in Lending, state by state usury laws, Equal Credit Opportunity, and the Gramm-Leach Bliley Act.” It is true that the Know Your Customer (KYC) statute, a cornerstone of fraud mitigation compliance in the financial services world, extends to Fintech and existing SBLCs based on the overarching definition of creditors that need to comply. But this is not the case for broader Bank Secrecy Act (BSA) and Anti Money Laundering (AML) standards. Even so, the salient point for this Committee and Congress is not that non-federally regulated creditors are required to comply with some fragments of these fraud mitigation concepts. The issue of concern here is whether SBA is *regulating* the lenders for which it is the primary regulator for these critical compliance concepts of fraud mitigation and the basic consumer protection laws which SBA enumerated. While SBA states that lenders are required to comply with BSA/KYC/AML and that the agency evaluates lenders on consumer protection laws, NAGGL has not found any written guidance on any of these concepts in regulations, SOPs, notices, or other program requirements.

As you are aware, SBA/OCRM does monitor transactional risk in the 7(a) program through the Loan/Lender Monitoring System (L/LMS) that scores every 7(a) lender’s portfolio on a quarterly basis and applies the tenets of a system called PARRiS that monitors lender and loan performance in the 7(a) program. L/LMS informs the frequency of lender reviews based on lenders’ loan volume, including periodically reviewing a sample of loans for compliance with SBA policies. And it is our understanding that currently OCRM performs Safety and Soundness exams only once every other year on existing SBLCs. However, monitoring loan performance is only a very small part of being a primary regulator, and missing from SBA’s approach are the very necessary ways that the federal regulators monitor lenders for institutional risk and compliance with the major components of both consumer protections and risk mitigation concepts.

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*Policy Notices and SOP Guidance Issued by SBA to Implement the Regulatory Amendments and Make Other Non-Regulatory Changes to the 7(a) Program:*

The lending industry is still digesting the various notices and the new SOP, all of which were issued just last week in the hours right before and after the hearing on these issues before this Committee. But it is clear that the changes in these additional piecemeal documents go well beyond what was included in the regulations and actually exacerbate our concerns about the changes being made to the 7(a) program.

As of the date when this testimony is being prepared, SBA has issued a number of documents intended to implement the regulatory amendments and to make other changes to 7(a) Program Requirements that are not covered in program regulations. These include:

- *Information Notice 5000-846818, Community Advantage Small Business Lending Company Conversion* (effective 5/1/2023);
- *Procedural Notice 5000-846607, Implementation of the Final Rule on Affiliation and Lending Criteria for the SBA Business Loan Programs (88 FR 21074, effective May 11, 2023)* (notice effective 5/9/2023);
- *Procedural Notice 5000-846991, Implementation of Removal of the Loan Authorization in accordance with the Final Rule on Small Business Lending Company (SBLC) Moratorium Recission and Removal of the Requirement for a Loan Authorization (88 FR 21890, effective 5/12/2023)* (notice effective 5/12/2023);
- *Information Notice 5000-847027, Issuance of SOP 50 10 7* (effective 5/10/2023); and,
- *SOP 50 10 7* (slated to take effect on 8/1/2023).

As to implementation of the regulatory changes, it appears that the recently released guidance and updated SOP attempt, on their surface, to provide additional details and to mitigate at least some of the risk appeared to have been created by the rule-changes.

For example, the notice implementing the final Affiliation Rule generally limits the removal of the underwriting criteria to loans of \$500,000 and under. This interpretation of the regulations makes some sense from a risk mitigation perspective. On the other hand, small loans are estimated to be more than 75% of all 7(a) loans made every FY—in other words, the majority of the portfolio still will have the newly imposed loosened guardrails.

And there are still valid and significant concerns related to increasing program risk even with this latest carve-out on smaller loans, especially as it relates to the policy notice's revised collateral and equity injection requirements, or lack thereof, for small loans and the exemptions made on both underwriting and equity injections for larger loans. For instance, SBA no longer specifies a mandatory equity injection (previously 10 percent) for any size loan made to a start-up business, and no longer specifically requires lenders to verify an equity injection unless they would do so for their own similar conventional loans. In addition, for loans over \$500,000, for loans made for complete changes of ownership, SBA provides additional discretion for a lender to decide to allow less than the current 10 percent mandatory equity injection. The new guidance also appears to allow lenders, regardless of loan size, to apply the "do what you do" standards when underwriting loans when loan proceeds will be used to refinance existing debt, conditions that could be of concern from a prudent lending standpoint.

In addition, among the most important of the non-regulatory changes included in the just-released guidance are changes that would increase the maximum size of a 7(a) Small Loan from \$350,000 to \$500,000, and would raise, from \$25,000 to \$50,000 the threshold below which SBA will not require any collateral to secure the 7(a) loan.

Of particular concern is the significant changes to the requirements relating to the determination that credit is not available elsewhere, the foundational principle of 7(a) lending. By statute, 7(a)



loans can only go to a borrower who could not receive credit conventionally on reasonable terms and conditions from non-Federal, non-State and non-local government sources. Historically, lenders have been required to document in each loan file the reason why the applicant could not obtain credit elsewhere. This is important—it assures that the SBA loan program is not competing with the private-sector. It means that SBA 7(a) loans are going to those borrowers who meet the program’s very specific public policy purpose. Shockingly, the new SOP transforms, for the first time, the credit elsewhere to a check-the-box automated process without requiring written justification in the lender’s credit memo. The fraud mitigation antenna of every Member of Congress should be raised by these changes. This is especially true given the recent issues relating to PPP check-the-box exercises and the IG community’s warnings that these practices in government programs can result in higher levels of fraud.

In addition, the SOP removes from consideration as a possible source of funding, the personal liquidity of the business owners – which means that the door has been opened for individuals with substantial personal resources to qualify for SBA-backed loans. SBA’s rationale for this change is that the “personal resources from owners enhance SBA’s ability to mitigate loan losses” by virtue of the personal guaranties provided by the owners. While that may be true, depending on whether the assets would still be available if there was a loan default, it also further illustrates why the personal liquidity of the business owners should continue to be an issue for consideration when deciding whether the loan applicant could obtain credit elsewhere.

Relegating important guardrails and concepts to SOPs, notices and other guidance outside of regulation, which could include informal documents such as FAQs, is a slippery slope. This strategy leaves the door open for this Administration and any future Administration to easily change critical policies unburdened by any requirement to solicit industry input or provide advance notice. If underwriting criteria, for instance, is a hallmark of protecting the program, then it should NOT be stripped from the more formal regulatory framework and allowed to be adapted or altered on a whim by policy notices or SOP revisions. And, since regulations take precedence over Policy Notices and SOPs, the conflict between the Final Rule and the implementing guidance documents which are slightly more prescriptive, creates both confusion and even possible loopholes for lenders who want to do what they do on all loans.

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### *Other Key Changes Made by SBA’s Final Rules*

Let’s dive into the details not covered above. Unfortunately, this sweeping deregulation of the 7(a) Loan Program does not stop with the issues framed above. Both the Affiliation Rule and the SBLC Rule also change many nuanced elements of the 7(a) Loan Program of which this Committee should be aware.

### Opening SBA Loans to Large Businesses

The changes to SBA’s affiliation requirements contained in the final Affiliation Rule are also concerning in that they remove the majority of the requirements related to how a small business

applicant is considered to be affiliated with a possibly larger business. Of greatest significance is the removal of examining control of one entity over another as a basis for affiliation. Consider management contracts or franchise and license agreements—these are all common business constructs that, in some cases, exert so much control and influence that the small business is actually a mere arm of the larger corporation, rather than a truly independent small business entity. However, these relationships will no longer be considered when determining affiliation, a massive change from pre-rule change requirements.

This Committee has recently considered these very issues. In 2018, the SBA OIG and the Office of Capital Access were called to testify before this Committee on issues relating to loans made to poultry farmers who were found to be affiliated with large poultry corporations. The IG said at the time the larger entities exercised such excessive control that the small business should not have been eligible for a SBA loan; however, SBA had told lenders these types of borrowers were eligible. On a bipartisan basis, Members of this Committee expressed serious concern that SBA loans were made to large corporations indirectly and even questioned whether credit elsewhere was met. And even more recently, PPP found itself in an affiliation-related debate when large, publicly-traded companies received PPP grants, and despite statute originally permitting those grants under the loosened guidelines, both Congress and the court of public opinion had very different takes on whether such companies should be receiving SBA-backed assistance. Both this Committee and the lending industry have been here before.

### The Politicization of SBA Lending

I am also concerned about the politicization of the processes around 7(a) loans that have, up until now, remained squarely within the bounds of career staff, but which would now be determined by political appointees. In the Affiliation Rule, SBA revises regulations to allow final reconsideration decisions regarding loan denials or loan modification requests to be made either by the Director, Office of Financial Assistance, as currently allowed, or by the Director's designee(s), both career positions. Note that this would only occur when a lender submits a loan for SBA's approval through a non-delegated process that is used by lenders to gain extra clarity on loan approvals or by lenders without delegated authority to make 7(a) loans. But the rule change also adds new language allowing the SBA Administrator discretion to review a reconsideration request and make the final Agency decision, though the SOP is silent on this concept.

This handing-over of unprecedented power to political appointees at the SBA should be worrisome for both sides of the aisle—Administrations change, political appointees change, and each, regardless of party, brings their own politically-driven goals. We should never politicize a program that aims to support Main Street America, and this change allows politics to seep into determining SBA loan approvals.

### Removal of Loan Authorization and the Lender Uncertainty

Historically, SBA has required that a separate loan authorization be generated for each 7(a) loan. The authorization spells out all of the terms and conditions under which the lender is making the loan to the borrower, and under which SBA is guaranteeing the loan for the lender and is

executed by both the lender and by SBA (with the lender signing on behalf of SBA, but subject to later view, for loans processed on a delegated basis).

The final SBLC Rule removes the term “authorization” wherever it appears in the regulations. That change took effect on 5/12/2023, and, while SBA has indicated that it will provide some substitute document, presumably to be generated by the 7(a) loan automation system, E-Tran, to reflect the mutually agreed-to terms and conditions for the individual loan, to date, SBA has not provided that alternative document. This has put lenders into a quandary since, in addition to cementing the terms and conditions under which the loan is made and guaranteed, the authorization document is relied on for various purposes, including providing the exact language that should appear in the SBA loan note (or lender equivalent) and resolving any issues that may arise about the loan terms if it is being sold in the secondary market. NAGGL agrees with SBA that the previous process for generating a loan authorization could be bulky. But, however the new document is to be named and generated, it is essential that that process occur immediately and that the new form include all of the terms and conditions lenders believe are necessary to assure that the loan will be legally enforceable and that the SBA guaranty can be relied upon. Therefore, we hope that SBA will move quickly and will consult with lenders to ensure that any new form meets their needs.

*Lending to Underserved Markets: SBA’s Stated Intent, NAGGL’s Concerns with the Final Rules’ Lack of Focus on Underserved Borrowers, and Current 7(a) Lending to Underserved Communities*

One of the single most significant changes between the Proposed Rules and the Final Rules was the complete removal of any mention of lending to underserved markets or making small dollar loans. This makes it appear that the stated intent of the regulatory changes no longer is supported by regulatory language, but rather just becomes a more amorphous concept based on the assumption that lifting guardrails and licensing more lenders will somehow result in more loans going to the entrepreneurs who need them most.

SBA acknowledges that creation of the Community Advantage (CA) category of SBLCs is intended as a means of making the CA Pilot Program which has existed as a pilot since 2011, permanent. This raises the question of whether SBA has the authority to provide any sort of path to permanency for a pilot program. But more concerning for this discussion is that here too, in the regulatory language, SBA has removed any mention of a focus on underserved markets.

However, the recent information notice, *Community Advantage Small Business Lending Company Conversion*, did add some context to the parameters around CA SBLC participation. Except for the changes specifically cited in the notice, the new CA SBLCs will follow current CA Pilot Program requirements as outlined in the current version of the *Community Advantage Participant Guide*. This includes having authority to make loans of \$350,000 and less and adhering to the requirement that at least 60% of the number of CA loans closed by the lender

meet the underserved market requirements currently in place for the CA Pilot Program. But the notice indicates that SBA will provide further guidance on SBA Loan Program Requirements for CA SBLCs through additional SBA notices and/or SOPs.

While NAGGL has previously expressed its support for making the CA Pilot Program permanent, we have serious concerns about the appropriateness of doing that through an Agency regulation and a notice. As we previously discussed regarding SBA's underwriting criteria, we worry that what was done by regulation and less formal guidance could be as easily undone if there is a change of Administrator, or even just a change of philosophy within the Agency. If I were a CA lender, I would now feel as if I was on even less stable footing than in a pilot program that had continued to enjoy SBA backing for over a decade. For this reason, we continue to support legislative action to make the CA Pilot Program permanent in order to give CA participants the security of statutory authorization.

Turning to the regular SBLCs, it is interesting to note that while SBA's stated goal for lifting the SBLC moratorium was to incentivize underserved lending, neither the Proposed or Final SBLC Rule contains any requirements for the newly added regular SBLCs to focus on smaller loans or to target underserved markets. Rather, there seems to be an assumption that the new regular SBLCs, which presumably will include Fintech, will make small dollar loans because in the Paycheck Protection Program (PPP), the majority of the fully forgivable "loans" delivered by fintech were in smaller amounts as compared to traditional lenders. Since no underwriting was involved in PPP, and no repayment was intended, PPP performance should never be cited as an appropriate means for predicting 7(a) loan performance. Also, it is important to note, that even though SBA has indicated that allowing additional SBLC licenses will result in more small dollar loans, neither the Final Rule, nor any other guidance issued to date restrict, in any way, the maximum size loan that a regular SBLC can make.

The odd linkage between Fintech and underserved markets is even more confusing given this Administration's and other leading Democrats' own findings about Fintech. This Treasury Department and Representative Clyburn have both issued scathing reports about Fintech's role in larger market risks and in facilitating PPP fraud in the very weeks surrounding the release of the SBA's rules when first proposed. In addition, it has been investigated by Representative Cleaver, CFPB, and others whether Fintech utilizes predatory practices that actually target underserved borrowers.

NAGGL and the 7(a) lending industry applaud SBA's stated mission of focusing on small dollar loans and underserved markets. In fact, 7(a) lending and the program's reach line up exactly with an industry focused on small dollar loans and underserved markets.

According to SBA's own data, in FY22, the 7(a) Loan Program delivered the following:

- FY22 was the highest gross volume year of 7(a) lending in the program's history at \$26.9 billion, with the exception of FY21 during which Congress mandated stimulus provisions of fee waivers and higher guarantees to stimulate volume during a global pandemic and which expired at the end of FY21—FY21 is falsely inflated anomaly data.
- Roughly 50% of all loans made were \$150,000 or smaller.

- Roughly 70% of all loans made were \$350,000 or smaller.
- It is estimated that more than 75% of all loans made are small dollar loans, or \$500,000 or smaller, which is the new threshold SBA just set to define small dollar loans (SBA does not publicly provide a breakdown of loans made from \$500,000 or smaller).
- Only 7% of all loans made were the largest loans of \$2 million or larger.
- SBA's Congressional Budget Justification set the target goal for 7(a) lending to underserved markets at 43%, and actual 7(a) lending in FY22 to underserved markets was 68% of all loans made, far exceeding SBA's goal.
- One-third of all loans were to minority borrowers—a number that's steadily on the rise.
- 25% of our borrowers didn't identify their race or ethnicity, so the actual percentage of loans to minorities is likely higher than the statistics indicate.
- African Americans are the fastest growing demographic in the program, with nearly \$1 billion in loans last year alone—nearly a 60% increase since FY17. And so far this year, loans to African Americans are up 52% in units and 72% in dollars compared to last year.
- Hispanics totaled \$1.85 billion—more than a 27% increase since FY17. And so far this year, loans to Hispanics are up 91% in units and 98% in dollars compared to last year.
- Loans in rural areas totaled roughly 20% of all loans.

These trends continue in FY23 statistics provided by SBA, year to date, and the current average loan size in the portfolio is roughly \$475,000, below the small dollar loan threshold amount of \$500,000.

We can always do more, but we cannot call these statistics market failures, as has sometimes been described by SBA.

We note that the gross number of units in loans \$150,000 and under fell by roughly 13,500 loans over the past 5 years. But during that time, at least two of the nation's largest banks stepped back from participating in SBA Express lending, a 7(a) sub-program that only allows small dollar loans, and a global pandemic put the smallest loans on the sidelines as borrowers either were not seeking small amounts of capital to expand and grow a business or pursued PPP, EIDL, and other stimulus programs. There are always going to be fluctuations in raw numbers year to year. But, in the last 5 years, these types of ebbs and flows are well-explained by macro circumstances and overinflating these statistical shifts fails to recognize that the delta between FY17 and FY22 on loans \$350,000 and under (well below the small dollar loan threshold of \$500,000) has actually only fluctuated from 74% to 68% of the whole portfolio, respectively. This is not a story of a market failure in small dollar loans.

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### *NAGGL's Stance on Alternative Lenders and How to Move Forward*

An argument has been made that those who oppose the program changes are doing so as a rejection of Fintech in the program. That just isn't the case.

However, part of the problem is that there is no single definition of the term “Fintech”. That term is used in many different ways, covering everything from the technology that the financial services industry uses to interact with customers, including extending credit, to designating a particular group of lenders involved in financial services by calling them “Fintech”. As to the first definition, not only do current 7(a) lenders not eschew technology, they embrace it with most lenders in the U.S. today, relying to greater or lesser degrees on technology and automation to support their customers and their programs. As to the second definition, the 7(a) industry already includes lenders that could be categorized as Fintech. So, it is a disservice to say that the 7(a) industry opposes opening the 7(a) program to greater use of, or participation by, Fintech. Instead, what we are urging is a more appropriate balancing of the potential risks of moving to greater automation and the addition of more non-federally regulated lenders against the benefits to be achieved by making those changes.

Several years ago, I personally led NAGGL to stake the position of welcoming with open arms credit unions into the 7(a) Loan Program when SBA proposed those changes. That was because I understood the goal of a government program is to aid and assist small business by attracting the widest variety of appropriately regulated financial entities to participate as program lenders. In addition to the types of Fintech-like entities and the majority of the active SBLCs already included in our membership, NAGGL also represents mission-based lenders, such as CDFIs and non-profit Community Advantage lenders who make loans in the 7(a) Loan Program’s Community Advantage Pilot Program. Both NAGGL and the 7(a) industry welcome any lender who will be a good steward of a government program which has the appropriate guardrails and regulator capacity.

So, the concern with these rules is not, and never has been, about Fintech or fear of competition. The concern with these rules is that it has removed the guardrails while bringing in entities that have no prudential regulator and SBA is unable to monitor and regulate these entities appropriately. SBA is not proposing to bring in non-federally regulated entities to the program we all know and trust. Rather, SBA is proposing to bring in non-federally regulated entities to a program now simultaneously stripped of many of the long-standing rules.

I honestly believe that because of these rule changes, at some point in the future this program will be performing at a loss rate that is not sustainable without Congress drastically increasing borrower and lender fees or providing taxpayer dollars. If neither happens, the program shuts down. We should all want this program to remain available for the borrowers for whom this program provides the only reasonable access to credit.

And this doesn’t even begin to scratch the surface on the impacts to the small business borrowers. When a program becomes more expensive for borrowers and lenders because losses are increased, underserved borrowers get left behind in a program that has suddenly become cost prohibitive. In addition, SBA’s lack of a regulatory framework may also threaten the most vulnerable borrowers given that SBA does not have guidance or oversight requirements surrounding some of the most basic consumer protection laws for the SBLCs it regulates. SBA does not have the means to know if its SBLCs are complying with Truth in Lending, Equal Credit Opportunity Act, and other cornerstones of borrower protections.

But even more damaging is that SBA is permitting, even encouraging, lenders to make the loan, rather than encumber them with underwriting criteria. When those kinds of guardrails are removed, it is likely that there will be a high volume of originations, especially from the non-federally regulated lenders that are not held to the higher standards imposed by the Federal Reserve, the FDIC, or the OCC. But if those lenders are not prioritizing repayment ability, a concept which is strengthened by considering all of the underwriting criteria now removed by SBA, then the result could be that borrowers are receiving loans that might not have sound repayment ability. Making a loan to a business owner who cannot repay the loan does not do that borrower any favors – it actually could ruin their life.

Finally, I would be remiss if I did not also state that, even if I agreed with every change that SBA is making – which, clearly, I do not – the Agency just is not ready to implement the regulatory changes. As noted above, SBA has not yet been able to provide a document to replace the traditional 7(a) loan authorization. In addition, SBA has not finalized the pre-eligibility SBA automation system that was discussed in testimony before this Committee, and in other discussions. SBA also has indicated that it will be providing some sort of automated pre-approval eligibility screening. And, again as far as we know, as of this date, that process has not been communicated to lenders, and would be hard to imagine is ready for roll-out as we speak. Finally, and most importantly, the only guidance that lenders have regarding implementation of the changes is what has been included in the written documents, including the new SOP 50 10 7 that will not take effect until 8/1/2023. This leaves lenders at a loss to understand what is now required of them and how they can ensure that they are operating in accordance with SBA requirements. Clearly, SBA needs to complete these implementation tasks. And SBA should have provided training for lenders before the Final Rules and other requirements took effect.

For all of the reasons cited in this testimony, and especially because of SBA's lack of readiness, I implore this Committee to act quickly to reverse these rules changes through a bipartisan legislative approach. Otherwise, SBA is inviting in the exact kind of behavior and risk that could erode the 7(a) Loan Program's performance and reputation, and even harm the very borrowers they are intending to help. My concern is and always will be about programmatic viability and integrity.

Thank you for the opportunity to testify, and I look forward to continuing the dialogue on these critical topics.