REVIEW OF THE RECOVERY ACT'S IMPACT ON SBA LENDING

Report Number: ROM 10-02

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Prepared by the
Office of Inspector General
U. S. Small Business Administration

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Eric Zarnikow
Associate Administrator for Capital Access

Date: November 25, 2009

From: Debra S. Ritt **/S/ Original Signed**
Assistant Inspector General for Auditing

Subject: Review of the Recovery Act's Impact on SBA Lending
Report Number ROM-10-02

This report presents our first review of the credit markets served by the U.S. Small Business Administration's (SBA) lending programs since the passage of the American Recovery and Reinvestment Act of 2009 (Recovery Act). Under the Recovery Act, SBA received $730 million to aid small business owners and stimulate small business lending. The Office of Management and Budget's (OMB) guidance for implementing the Act stresses accountability and requires agencies to ensure that funds are strictly monitored. In response, the Office of Inspector General (OIG) is performing periodic reviews of SBA program data to identify program trends and determine how well the Recovery Act is meeting its goals.

While SBA publishes monthly performance reports, they provide a limited view of lending activity and the Recovery Act's impact. Our objectives in this review were to: (1) provide transparency on SBA loan activity and lender participation under the Recovery Act; and (2) determine the impact of program changes on the levels and characteristics of SBA lending. This report presents our initial observations regarding trends and potential risk areas in SBA lending programs. While we identified some possible causes, our comments are not presented as conclusions. We will monitor these trends as we continue our oversight and review in this area.

The primary source of information for our review was loan data extracted from SBA's Loan Accounting System. To measure the impact of the Recovery Act, we established a baseline of 7(a) and 504 loan activity between January 1, 2007 and February 16, 2009. We compared 7(a) and 504 loan activity funded by the Recovery Act between February 17, 2009 and July 31, 2009 to this baseline to determine the responsiveness of the credit markets to the Recovery Act programs.

A more detailed discussion of our review scope and methodology is provided in Appendix I. The results below exclude loans not funded by the Recovery Act. These loans accounted for 4.1 percent of 7(a) loan approvals, the majority of which were SBA*Express* loans, and 0.4 percent of loan 504 approvals.

We conducted our review from July 2009 to September 2009 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

On November 20, 2009, the Associate Administrator for Capital Access provided formal comments to the OIG's draft report, generally agreeing with the report's findings. His comments also provided some clarification to report statements about SBA*Express* lending activity and its impact on Agency staffing requirements and program risk.

BACKGROUND

On February 17 2009, the Recovery Act was signed into law in response to the economic crisis. Many small businesses had been hit especially hard as banks started tightening credit in early 2007. Since September 2007, SBA loan approvals have been trending downward, reaching their lowest levels in February 2009. As economic conditions worsened, activity in SBA's secondary market also declined. Beginning in October 2008, the volume of SBA loans sold into the secondary market plunged, and in January 2009 reached its lowest level in over 5 years.

The Recovery Act provided SBA with $730 million to increase the availability of credit to small businesses. In response, the Agency modified existing programs and implemented new programs aimed at stimulating loan activity. On March 16, 2009, SBA launched two key initiatives. First, certain fees in the 7(a) and 504 loan programs were temporarily eliminated to lower the cost of the program for borrowers and lenders and encourage participation in SBA's lending programs. The Recovery Act also increased SBA's guaranty on most 7(a) loans (with the exception of SBA*Express* loans) to 90 percent in order to reduce lender risk and encourage increased lending. The Agency was appropriated $375 million to implement these programs.

In addition, SBA launched the America's Recovery Capital (ARC) loan program to help viable small businesses make existing debt payments, implemented changes to its 504 loan program to allow debt refinancing, raised limits in the Small Business Investment Company and Surety Bond programs, and used increased funding to expand the Microloan program. As of the time of this review, the Agency had not implemented the secondary market programs of the Recovery Act.

RESULTS IN BRIEF

Both 7(a) and 504 lending increased sharply since the Recovery Act. From March to July, 7(a) and 504 loan approvals jumped 39 percent and 73 percent, respectively. While the improvement is significant, both 7(a) and 504 loan approvals remained below 2008 and 2007 levels.

The SBA*Express* program had not responded as quickly as the rest of 7(a) lending. July approvals were just 13 percent higher than in March. Our review showed that SBA*Express* loan approvals have trended downward since 2007. The historical decline in program volume and weak response under the Recovery Act may suggest broad concern about the program's risk from lenders.

Small and medium lenders in the 7(a) program recovered more quickly, with loan activity returning to year-ago levels, and have taken on a larger share of SBA lending. As a result, loan activity has become more widely dispersed since the Recovery Act with the top 20 lenders accounting for 38 percent of all 7(a) loans (excluding SBA*Express*), compared to 53 percent in 2007. During the audit period, 256 new and returning lenders made loans. These lenders, which were either new to SBA lending or had not made a loan since January 2007, have been mostly smaller lenders making one or two loans. While they account for just 4 percent of total dollar volume under the Recovery Act, the addition of new lenders is a positive sign for the recovery and underscores the role being played by smaller lenders.

Our review found that an increased trend in SBA-approved loans in the 7(a) and 504 loan programs may be impacting Agency staffing requirements and program risk. In the 7(a) program, the number of SBA-approved loans more than doubled from March to July in the Recovery period. Without adequate training and supervision, the increased demands on loan center staff could impact the quality of Agency loan reviews.

The shift towards SBA-approved loans was also substantial in the 504 program, with the share of Agency-approved loans jumping to 94 percent of total loan approvals, from 80 percent 2 years ago. Efficiency gains in Agency processing times, combined with weaker economic conditions, may have reduced the incentive for Certified Development Companies (CDCs) to use their delegated authority to approve loans. If CDCs continue to send more loans to the Agency for approval, the Agency would lose the CDCs' contribution to any losses should these loans default.

RESULTS

7(a) and 504 Lending Increased Significantly Since Implementation of the Recovery Act Provisions

7(a) Loan Program

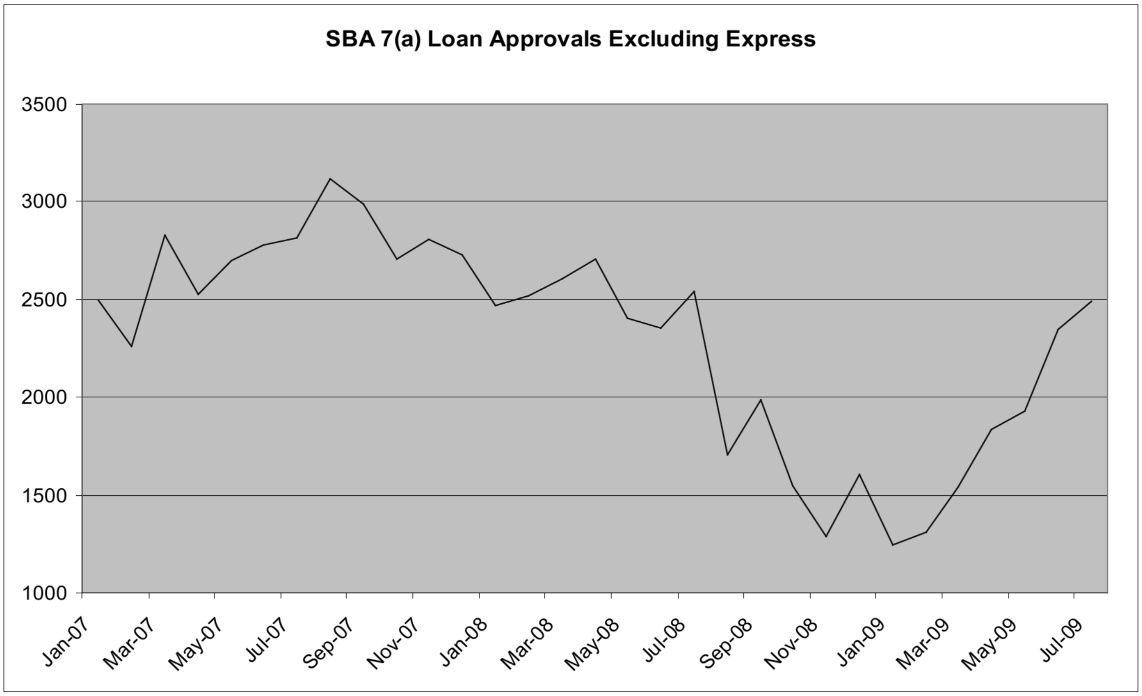
Loan activity in the 7(a) program increased significantly since the Recovery Act. Through July, SBA-approved 19,138 Recovery Act loans worth $4.2 billion, slightly more than its fiscal year Recovery Act target. Loan approvals increased 39 percent between March 1 and July 31. Despite the sharp rise in the recovery period, loan approvals remained below historical levels (Figure 1). Average monthly loan volume during this period was 3,600, or less than half of what it was over a similar period in 2007.

Figure 1. 7(a) Lending Activity

Source: SBA Loan Data

Within the 7(a) program, SBA*Express* had not shown significant improvement, masking a stronger recovery in the rest of 7(a) (Figure 2). Excluding SBA*Express* loans, July loan approvals were up 62 percent since March, approaching the levels a year ago in 2008. Still, average monthly loan approvals from March through July were 20 percent below 2008 levels and 26 percent below 2007.

Figure 2. 7(a) Activity Excluding SBAExpress



Source: SBA Loan Data

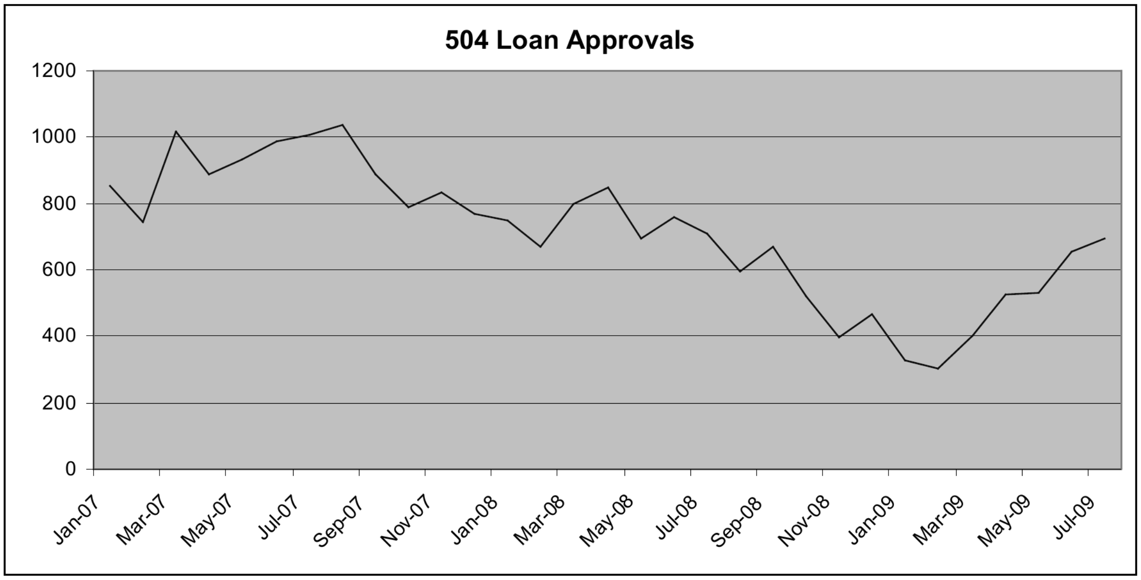
While loan approvals increased sharply under the Recovery Act, only about half the loans had been disbursed. Through June 30, \$1.7 billion of the \$3.3 billion in 7(a) loans approved under the Recovery Act had been disbursed to borrowers.[1] Because there is a lag in disbursement time, loan approvals are not the best measure of economic impact. Greater transparency would be achieved by including disbursement data, in addition to approval data, in the Agency's monthly performance reports.

504 Loan Program

Approvals of 504 loans in July were 73 percent above March levels, and just 2 percent below the same period in 2008 (Figure 3). Average monthly loan approvals from March to July were 26 percent below 2008 levels and 42 percent below 2007 levels.

[1] Disbursement data for 7(a) loans approved in July was not available at the time of our review.

Figure 3. 504 Lending Activity



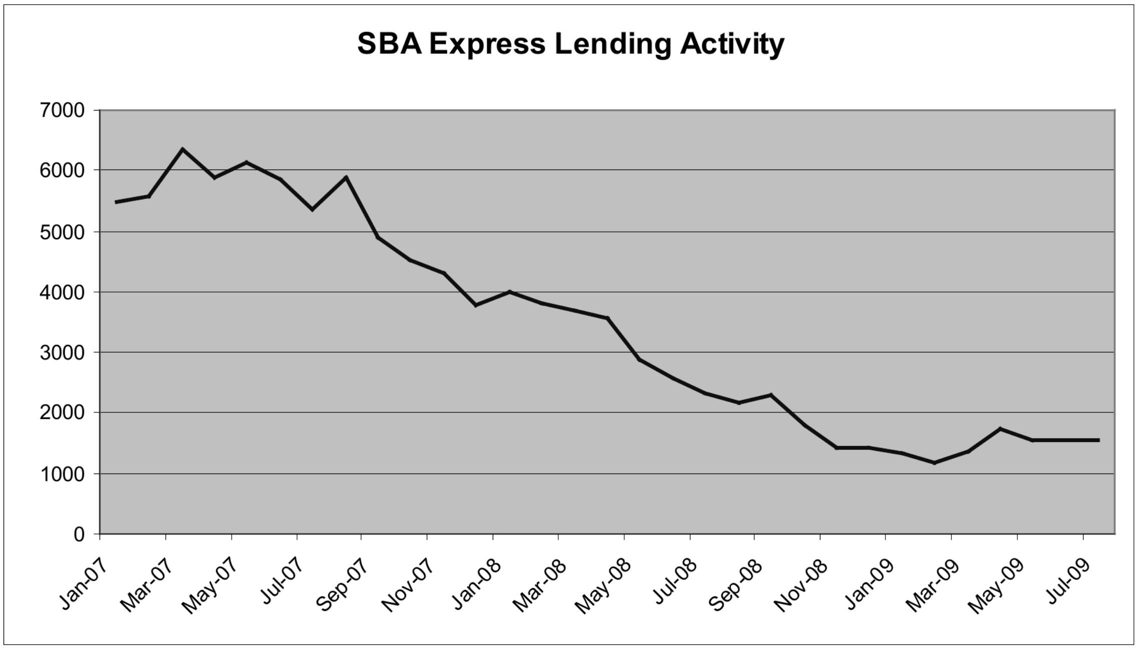
Source: SBA Loan Data

In the 504 loan program, loans are generally used to fund construction projects. Unlike the 7(a) program where funds are disbursed by lenders upfront, SBA does not issue its debenture to fund a 504 loan until the project has been completed. To cover project costs during construction, the 504 program allows borrowers to secure interim financing from a third party. Thus, the economic impact of a 504 loan is realized when the interim financing is disbursed. Therefore, loan approvals in this program are a more appropriate indicator of economic impact.

SBA*Express* Had Not Improved as Significantly as the Rest of the 7(a) Program under the Recovery Act

Although SBA*Express* activity had increased since bottoming out earlier this year, July approvals were just 13 percent higher than in March, and much lower than in previous years (Figure 4). Average monthly approvals from March through July were about half of 2008 levels and less than a third of 2007 approvals. The slower turnaround in loan approvals may be attributable to less stimulus from the Recovery Act or issues that preceded the Recovery Act.

Figure 4. SBAExpress Lending Activity[2]



Source: SBA Loan Data

Unlike the other 7(a) lending programs, the Recovery Act did not raise the guaranty level of SBA*Express* loans. While a lender can secure up to a 90-percent guaranty on other types of 7(a) loans, SBA*Express* loans remain at a 50-percent guaranty level. However, the Act did reduce SBA*Express* guaranty fees for borrowers.

The program's decline since 2007 resulted in a significant shift in the 7(a) lending portfolio. In 2007, SBA*Express* represented 66 percent of total 7(a) loan approvals. This declined to 43 percent under the Recovery Act. In its fiscal year 2008 financial report, SBA reported that the decline in SBA*Express* lending was predominantly due to a number of large lenders reducing or discontinuing their participation in the program due to their losses. The program is among SBA's riskiest for lenders, with a loan purchase rate that exceeded the rate of other 7(a) loans[3] over the last year.

The historical decline in program volume and weak response under the Recovery Act may suggest continued lender concerns about their risk of loss under the program. The substantially lower guaranty level, together with the program's higher loss rates, may explain why SBA*Express* has not responded as significantly under the Recovery Act.

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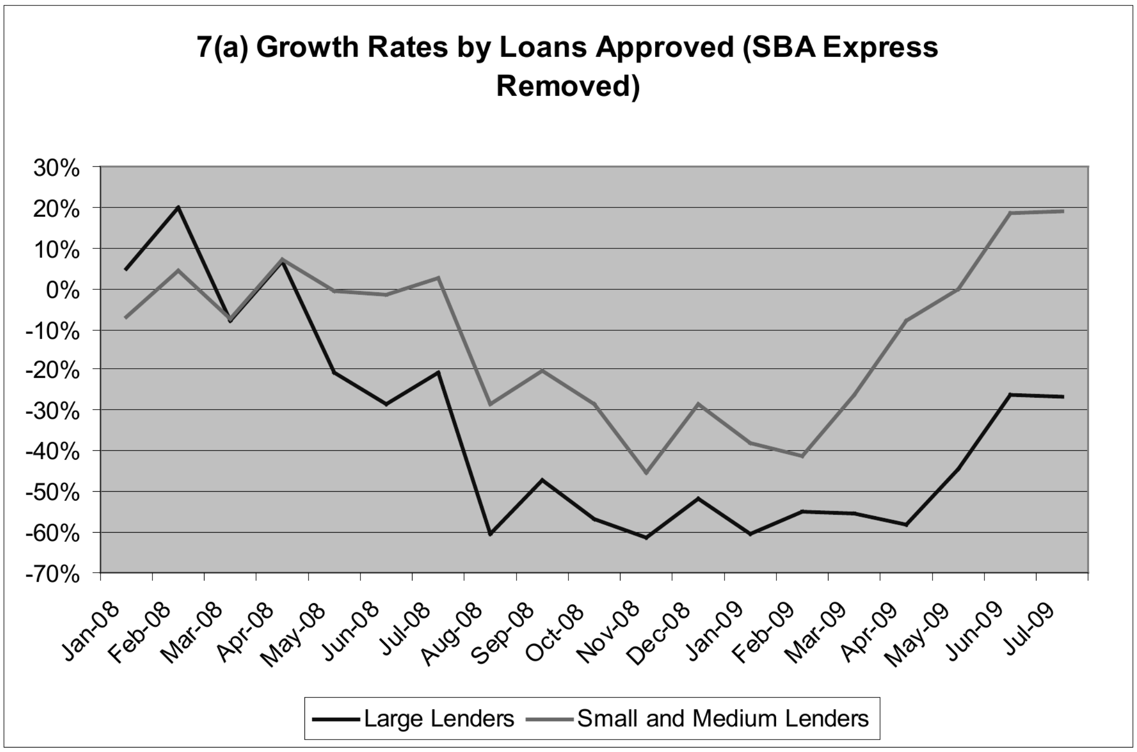
[2] SBA*Express* loan activity between February 17 and July 31, 2009 only includes loans funded by the Recovery Act. An additional 723 SBA*Express* loans that were not funded by the Recovery Act were approved over this time.

[3] This includes 7(a) loans made under the Preferred Lenders Program and SBA-approved loans.

Small and Medium Lenders Had Driven the Recovery in SBA Lending

Excluding SBA*Express* loans, SBA's small and medium lenders had been driving recovery. While these lenders did not cut back their lending as severely as the program's largest lenders in the year prior to the Recovery Act,[4] they responded immediately to SBA's implementation of reduced fees and increased loan guaranties (Figure 5). In July 2009, small and medium lenders[5] approved 19 percent more loans than a year ago compared to the largest lenders that are 27 percent below prior year levels.

Figure 5. Year over Year 7(a) Approval Growth Rates



Source: SBA Loan Data

As a result, 7(a) lending had become more widely dispersed under the Recovery Act. The top 20 lenders accounted for 38 percent of all 7(a) loans (excluding SBA*Express*) approved during the audit period, compared to 46 percent in 2008 and 53 percent in 2007. The largest 7(a) lenders contributed significantly to recovery volume, however they were not lending as much as they did a year ago. We found that three of the most severe cuts in loan activity have been attributable to SBA lenders that experienced significant financial problems in the past year.

[4] Large lenders are defined as the 20 largest lenders by loan volume during calendar year 2008.
[5] Small and medium lenders are defined as all other lenders.

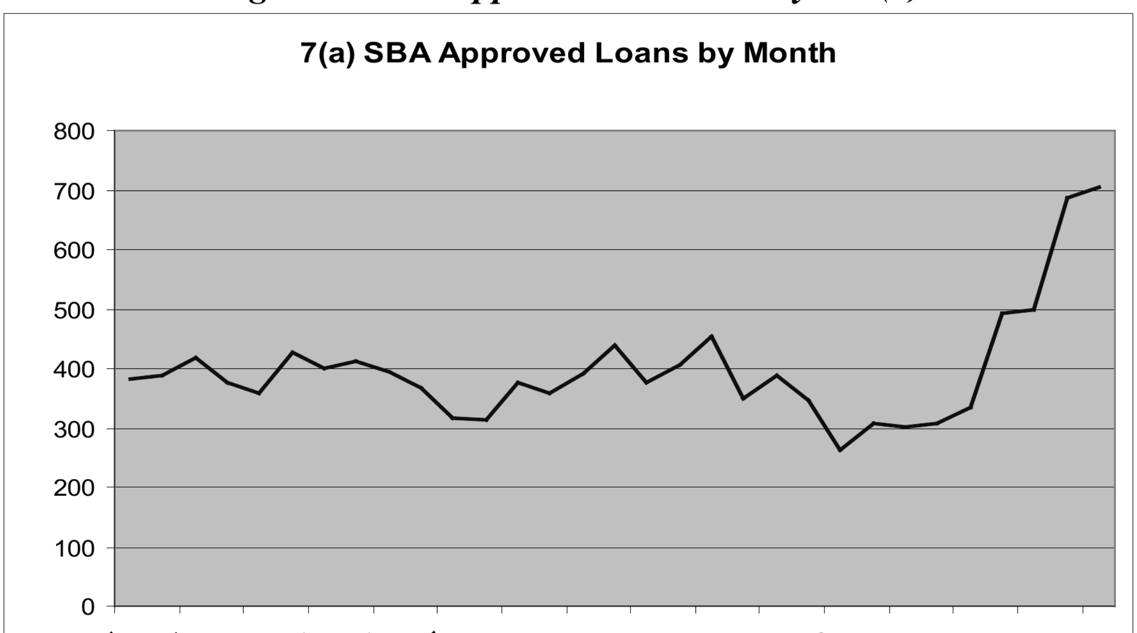
During the audit period, 256 new and returning lenders participated in SBA lending programs. These lenders, which were either new to SBA lending or had not made a loan since January 2007, were mostly smaller lenders making one or two loans. Their activity underscores the role being played by smaller SBA lenders in the recovery period. While these lenders account for just 4 percent of total dollar volume under the Recovery Act, the fact that lenders are being drawn to the 7(a) program is a positive development.

Increased Trend in SBA-Approved Loans in the 7(a) and 504 Loan Programs May Impact Agency Staffing Requirements and Program Risk

Increase in SBA-approved 7(a) Loans

During the audit period, the number of 7(a) loans approved by SBA had more than doubled, increasing demands on staff at SBA loan centers. In July, SBA approved 705 loans compared to only 333 in March (Figure 6). In fact, the percentage of SBA-approved 7(a) loans continued its upward trend, and in July represented 28.3 percent of all approved 7(a) loans (excluding SBA*Express*).

Figure 6. SBA-Approved Loan Activity in 7(a)



Source: SBA Loan Data

SBA faces a risk that the increased demands on loan center staff could impact the quality of Agency loan reviews if adequate staff and training are not provided. The Agency must ensure that the quality of review is not sacrificed to meet the increased demands on SBA loan center resources. Some of our concern stems from the preliminary results from our current review of a sample of 7(a) loans disbursed under the Recovery Act, to determine whether they have been originated and closed in accordance with SBA's policies and procedures. To date, we have found evidence of weaknesses in the Agency's review and approval process for 7(a) loans. In the sample, we found that the Agency approved multiple loans where lenders did not use the correct cash flow methodology. We also found instances where SBA did not adhere to its own standards for allowable goodwill in change of ownership transactions. These deficiencies raise a concern that the shift towards agency approval of 7(a) loans could lead to increased losses and improper payments. While the Agency has developed a staffing plan and begun adding staff under the Recovery Act, it must ensure that staff are properly trained and supervised to mitigate the risk of increased program losses.

CDCs Shift to SBA-approved 504 Loans

The shift towards SBA approval is also significant in the 504 program. In the recovery period through July, Certified Development Companies (CDCs) have relied on SBA to process about 94 percent of total loans, up from 80 percent 2 years ago. The program's most active lenders with delegated authority—participants in the Premier Certified Lenders Program (PCLP)—have substantially increased the number of loans sent to SBA for approval. In 2007, the 10 most active PCLP CDCs approved 77 percent of their loans using delegated authority, compared to just 30 percent by the same CDCs under the Recovery Act. The two largest PCLP CDCs that had approved 99 percent of their 2007 loans using delegated authority, have only approved 28 percent under the Recovery Act. The shift towards Agency approval of 504 loans places SBA in a position to assume a greater share of program risk.

Historically, PCLP CDCs had the benefit of much faster processing times by using their delegated authority. Through increased efficiencies at SBA's loan centers following centralization, much of this benefit has been eliminated. According to SBA, it currently takes the Agency 2 days longer on average to process a loan through its Accredited Lenders Program than for a CDC using its delegated authority. As a result of the center's processing efficiency improvements, PCLP CDCs have little incentive to approve their own 504 loans.

The impact of this shift is that the Agency loses the PCLP CDCs' contribution to loan losses. PCLP participants must maintain a loan loss reserve fund to reimburse SBA for 10 percent of any Agency loss in the event of default. For each PCLP debenture that it issues, the CDC must maintain a reserve equal to 1 percent of the original principal amount. There is no reserve or reimbursement requirement when the Agency approves a loan. PCLP CDCs thus free up additional capital by sending their 504 loans to SBA for approval, which may be an increasingly important incentive under current economic conditions. As a result, the Agency may face increased exposure to losses upon loan default.

Efficiency gains in Agency processing times, combined with weaker economic conditions, may have reduced the incentive for CDCs to use their delegated authority to approve loans. If this change in CDC behavior continues, it may increase SBA's risk of loss, as the Agency could lose the CDCs' 10-percent participation in loan losses. SBA should monitor this trend to determine its potential impact on program costs for CDCs.

AGENCY COMMENTS

On November 19, 2009, we discussed the draft report with the Associate Administrator for Capital Access and on November 20, he provided written comments. The written comments are summarized below, and the full text of the comments is provided in Appendix II to this report.

SBA management generally agreed with the findings, but provided some clarifications to the report statements relating to SBA*Express* lending activity and its impact on SBA staffing requirements and program risk. Management commented that the rebound in SBA*Express* activity has not been as considerable as in the 7(a) program overall, which is potentially due to the unchanged guaranty level during challenging economic conditions. Management also commented that in anticipation of the increased loan transactions under the Recovery Act, the Agency took a disciplined approach to developing staffing estimates to forecast staff capacity needs, and recruited staff with previous lending experience and expertise who would be able to process loans faster than less experienced new hires. New hires also underwent a 2-week training program. Additionally, management noted that they will continue to actively monitor 504 program performance in light of increases in SBA-approved loans.

APPENDIX I. SCOPE AND METHODOLOGY

Our audit objectives were to: (1) provide transparency on SBA loan activity and lender participation under the Recovery Act; and (2) determine the impact of program changes on the levels and characteristics of SBA lending.

To satisfy the audit objectives, we collected data from SBA's Loan Accounting System (LAS) for all 7(a) and 504 loans issued from January 1, 2007 through February 16, 2009. We did this to establish a baseline for loan activity prior to the Recovery Act. Next, we collected LAS data from February 17, 2009 (the day the Recovery Act passed) to July 31. We did not adjust SBA's approval data for cancelled loans. Also, all years in this report refer to calendar years, unless noted otherwise.

We reviewed the six weeks of data for the America's Recovery Capital (ARC) loan program that was available at the time of our review. In order to provide a more thorough review of activity in the ARC loan program, we plan to report separately as more data becomes available.

Although we initially planned to review the Recovery Act's impact on secondary market liquidity, SBA had not yet implemented its program establishing secondary market lending authority at the time of our review. As such, we chose to focus on primary market activity and lender participation.

To verify the reliability of the collected data, we discussed data system controls with SBA officials and conducted our own data testing.   To validate collected data, the analysts performed; error testing, parameter testing, reasonableness testing, analysis of blank fields, and completeness testing of key data fields. We utilized Computer-Assisted Audit Techniques (CAATs) and Microsoft Office applications to ensure that performance related data is accurate.

We used IDEA data analysis software to run queries on data extracted from LAS. We ran tests to examine loan activity levels and characteristics. Finally, we exported the results of the IDEA queries into Excel workbooks to continue our analysis and to construct tables and charts for presentation.

We conducted our review from June 2009 through September 2009 in accordance with *Government Auditing Standards* prescribed by the Comptroller of the United States and included such tests as were considered necessary to provide a reasonable assurance of detecting abuse or illegal acts.

APPENDIX II. AGENCY COMMENTS

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: November 20, 2009

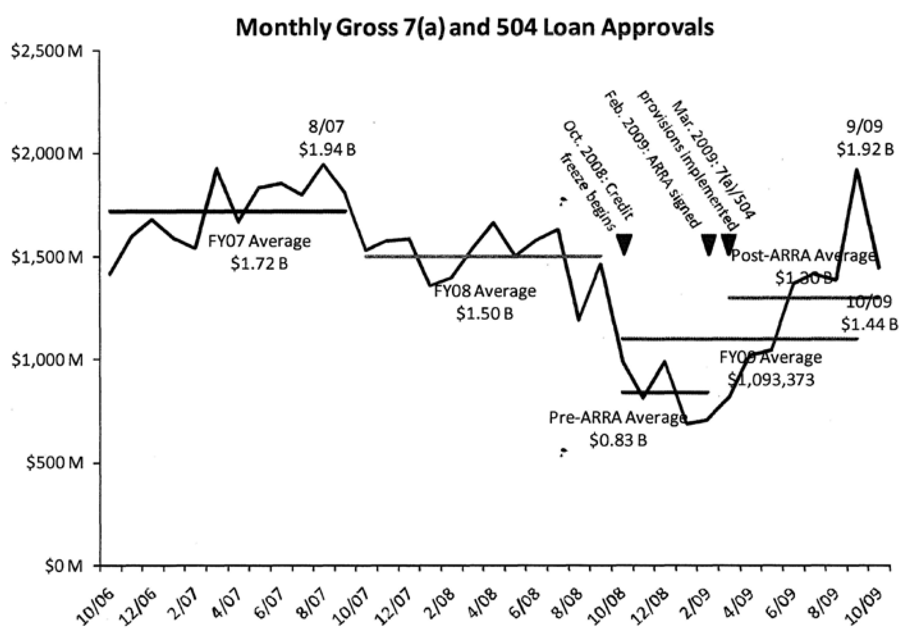
TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow [FOIA ex. 6]
Associate Administrator for Capital Access

SUBJECT: Draft Report on the Recovery Act's Impact on SBA Lending Markets
Project No. 9515

Thank you for the opportunity to comment on the referenced draft report.

The SBA has indeed seen improvement in increasing access to capital for small businesses since the implementation of the American Recovery and Reinvestment Act of 2009 (ARRA or Recovery Act). In October 2008, credit markets, including SBA's, froze, and the SBA secondary market slowed dramatically. On March 16, SBA implemented two critical Recovery Act provisions: increased guarantee level up to 90% on 7(a) loans (excluding SBA Express), and fee reductions in both the 7(a) and 504 programs. As identified in the OIG report, these provisions have helped drive significantly improved loan volumes from the depths of the crisis. As of October 30, SBA approved $10.2 billion in Recovery Act loans, and supported $13.9 billion in lending to small businesses. Since the signing of ARRA, weekly loan dollar volumes have risen 76% in the 7(a) and 504 programs, compared to the weeks preceding ARRA's passage. (See chart below.)



NOTE: All loan volumes are gross loan value approved. Typically, due to cancellations and loan size reductions, 15 – 20% of gross approval value does not get disbursed.

Although the SBA agrees with OIG's report results about this increase in 7(a) and 504 lending, the SBA would like to make some clarifications about the statements relating to SBA Express lending activity, as well as how SBA lending activity may impact staffing requirements and program risk.

OIG Results: *SBA Express Had Not Improved as Significantly as the Rest of the 7(a) Program Under the Recovery Act*

SBA Response:

- SBA agrees that while volume in the SBA Express Program has also increased (43% higher weekly average in FY09) since implementation of Recovery Act, the rebound has not been as considerable as in the 7(a) program overall, potentially due to the unchanged guaranty level in this challenging economic environment.

- Furthermore, this trend underscores the importance of the Recovery Act and the higher guaranty level in contributing to the rebound in SBA lending volume.

OIG Results: *Increased Trend in SBA-Approved Loans in the 7(a) and 504 Loan Programs May Impact Agency Staffing Requirements and Program Risk*

SBA Response:

- SBA agrees that processing volume has increased with the implementation of ARRA loans. By June, there was an 80% increase in non-delegated 7(a) loan applications over the months leading up to ARRA. 504 loan applications (non PCLP) were 33% higher after the stimulus than for the same calendar months last year.

- Given the credit crisis, it was the clear intention of Congress that the Recovery Act provisions be implemented expeditiously. As we planned for the ARRA implementation, we recognized that we would need substantial staffing resources to process the expected increase in loan application transactions. Furthermore, this increase in staffing would have to take place in a short time period to handle the estimated volume of loans. Therefore, we approached the needed addition of staffing and the related training with a high degree of urgency.

    - **Staffing impact**: Prior to the implementation of ARRA, the Office of Capital Access and the Office of Financial Program Operations took a disciplined approach to developing staffing estimates to forecast staff capacity needs, despite a high level of uncertainty about program demand over the coming months.

    - **Training of staff:** In order to meet the very quick ramp-up required to process ARRA loan programs, OFPO took steps to attract new staff with previous SBA lending experience and expertise. In many cases this experience allowed these individuals to progress toward processing loans at a faster pace than would be expected from less experienced new hires. As part of the on-barding process, new hires received a two-week training program covering ethics, basic processing, SBA standard operating procedures, and reporting systems, plus a week of on the job training. Following this initial two-week training, loan specialists were closely supervised to ensure quality of their work product. The centers emphasized quality in the loan review process, while also recognizing that volume production was needed as part of the Recovery Act implementation.

- **CDC shift to SBA-approved 504 loans:** The Agency has noticed that a larger share of 504 loans from PCLP lenders have come to SBA for approval and understands the shifting tradeoffs for CDC in processing applications on a delegated basis, versus submitting to SBA for approval. SBA will continue to actively monitor program performance in the 504 program.

Again, we thank you for the opportunity to comment on this report. Please do not hesitate to contact me with any additional questions.