White Paper: 7(a) Loan Program During SBA's Response to the COVID-19 Pandemic

Report 23-05 | March 21, 2023

Executive Summary

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Why OIG Reviewed the Program

We prepared this white paper to report on the U.S. Small Business Administration's (SBA) 7(a) loan program performance during SBA's response to the Coronavirus Disease 2019 (COVID-19) pandemic and address potential risks SBA should consider in managing the program.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was enacted to provide economic relief to small businesses and alleviate hardships created by the COVID-19 pandemic. The Act, combined with subsequent legislation, required SBA to administer over a trillion dollars in pandemic relief funding in addition to its responsibility to administer its flagship 7(a) program, along with its other vital programs.

Section 1112 of the Act provided $17 billion in relief payments for 7(a) loans. SBA was authorized through September 27, 2020 to pay 6 months of principal, interest, and any associated fees owed on a covered loan in regular servicing status.

On December 27, 2020, the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act reinstated the relief program from February 1, 2021 through September 30, 2021.

What OIG Reviewed

Our objective was to assess 7(a) loan program performance during SBA's response to the COVID-19 pandemic. To accomplish our objective, we analyzed 7(a) loan data from fiscal years (FY) 2018 through 2022. We reviewed CARES Act, Economic Aid Act, SBA guidance; and interviewed SBA officials regarding its program oversight.

What OIG Found

We identified factors that could impact the 7(a) loan program and should be considered in SBA's program risk strategy. Specifically, in FY 2021, the total amount of loans increased to $31.4 billion from $19.4 billion in FY 2020 (62 percent increase) and $20.6 billion in FY 2019 (53 percent increase), as did the average loan amount. Loan approvals decreased in FY 2020 and returned to pre-pandemic levels in FY 2021. Default and charge-off rates also significantly declined after implementation of the CARES Act.

Oversight staffing levels in the Office of Credit Risk Management decreased from 42 to 26 employees, or by 38 percent. This staff reduction could affect SBA's FY 2023 goal for oversight reviews, which help ensure lender compliance with program requirements.

The relief payments likely attributed to declining default and charge-off rates. Small businesses also had access to additional support during the COVID-19 pandemic, which included the Paycheck Protection Program, the Restaurant Revitalization Fund, Economic Injury Disaster Loans, and deferred 7(a) loan payments. However, variable interest rates for 7(a) loans increased because the base prime rate increased from 3.25 percent to 6.25 percent in 2022. The effects of the pandemic combined with the rising interest rates could increase the risk for subsequent defaults and charge-offs. These program trends could increase SBA's liability and have a negative impact on its ability to achieve its zero-subsidy rate goal.

Key Consideration for SBA

To ensure 7(a) loan program integrity, reduce the risk of financial loss and facilitate meeting its zero-subsidy rate goal, SBA should consider potential risks related to higher loan amounts, rising interest rates, staffing shortages, delayed defaults, and charge-offs in its 7(a) risk strategy.

Office of Inspector General

U.S. Small Business Administration

DATE: March 21, 2023

TO: Isabella Casillas Guzman
Administrator

FROM: Hannibal "Mike" Ware
Inspector General

SUBJECT: White Paper on the 7(a) Loan Program During SBA's Response to the COVID-19 Pandemic

We prepared this white paper to report on the U.S. Small Business Administration's (SBA) 7(a) loan program performance during SBA's response to the Coronavirus Disease 2019 (COVID-19) pandemic and to address potential risks SBA should consider in managing the program.

Background

SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was enacted to provide economic relief to small businesses, alleviating hardships created by the COVID-19 pandemic. Section 1112 of the CARES Act provided $17 billion in relief payments for loans made under section 7(a) of the Small Business Act. SBA was authorized through September 27, 2020 to pay 6 months of principal, interest, and any associated fees owed on a covered loan in regular servicing status. The CARES Act also indicated that the agency should encourage lenders to provide payment deferments when appropriate and to extend the maturity of covered loans.

On December 27, 2020, the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act reinstated the debt relief program from February 1, 2021 through September 30, 2021.

Key 7(a) Loan Program Changes

Throughout the pandemic, SBA issued guidance to inform lenders of changes to the 7(a) loan program. Significant changes included:

- The SBA guaranty percentage for 7(a) loans increased from the traditional 75 or 85 percent to 90 percent.
- The SBA guaranty percentage for Express Loans less than or equal to $350,000 increased from 50 percent to 75 percent. The maximum loan amount for Express Loans increased from $350,000 to $1 million and then decreased to $500,000.[1]
- The Economic Aid Act eliminated SBA guaranty and annual service fees for 7(a) loans on December 27, 2020.

In addition, SBA directed its lenders on making determinations regarding changes in borrowers' financial conditions due to the pandemic and advised them to conduct additional credit analyses as evidence that they performed a prudent underwriting and financial analysis of the borrower. SBA also implemented the 6 months of 7(a) loan payments provided by Section 1112 of the CARES Act.

Objective

Our objective was to assess 7(a) loan program performance during SBA's response to the COVID-19 pandemic.

Results

We identified factors that could impact the effectiveness of the 7(a) loan program and should be considered in SBA's program risk strategy. Overall, in FY 2021, the average 7(a) loan amount increased to $681,094, which was $150,682, or 28 percent, higher than in FY 2020. Accordingly, the total amount of loans increased to $31.4 billion from $19.4 billion in FY 2020 (62 percent increase) and $20.6 billion in FY 2019 (53 percent increase). Loan approvals decreased in FY 2020 and returned to pre-pandemic levels in FY 2021. The default and charge-off rates significantly declined after implementation of the CARES Act. In FY 2021, the default and charge-off rates were 1.02 percent and 0.15 percent, respectively, compared to the FY 2018 default rate of 9.04 percent and charge-off rate of 4.75 percent. The 6 months of relief payments, which ended on September 30, 2021, alleviated some of the economic hardships COVID-19 caused to qualified small businesses and likely attributed to declining default and charge-off rates.

However, the variable interest rates for 7(a) loans increased from 3.25 percent to 6.25 percent in 2022. The effects of the pandemic combined with the rising interest rates could increase the risk for subsequent defaults and charge-offs. In addition, oversight staffing levels in the Office of Credit Risk Management decreased by 38 percent. These program trends could increase SBA's liability and have a negative impact on its ability to achieve its zero-subsidy rate goal. To ensure 7(a) loan program integrity, reduce the risk of financial loss, and facilitate meeting its zero-subsidy rate goal, SBA should consider potential risks related to higher loan amounts, rising interest rates, staffing shortages, delayed defaults, and charge-offs in its 7(a)program risk strategy.

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[1] The $1 million maximum loan amount was in place from March 27, 2020 through October 1, 2021, before decreasing to $500,000.

Potential 7(a) Loan Program Risks

The average 7(a) loan amount significantly increased in FY 2021. Specifically, the average loan amount was about $681,000, which was $151,000, or 28 percent, higher than in FY 2020. Prior to the pandemic in FY 2019, the average loan amount was about $450,000, which was $30,000, or 7 percent, higher than in FY 2018. This difference in increase from 7 to 28 percent likely occurred because the Economic Aid Act increased SBA's guaranty percentage and eliminated the guaranty fee. Higher loan amounts increased SBA's guaranteed portion and, therefore, increased its financial risk.

In FY 2021, the 7(a) loan program had a default rate of 1.02 percent and a charge-off rate of 0.15 percent. These rates are significantly lower than the FY 2018 default rate of 9.04 percent and charge-off rate of 4.75 percent. This difference likely occurred because Section 1112 of the CARES Act provided borrowers with 6 months of 7(a) loan payments. Small businesses also had access to additional support during the COVID-19 pandemic, including the Paycheck Protection Program, the Restaurant Revitalization Fund, Economic Injury Disaster Loans, and deferred 7(a) loan payments.

As many of the aforementioned programs sunset and interest rates rise, borrowers' ability to repay 7(a) loans could be affected. Variable interest rates on 7(a) loans are based on the prime rate, which significantly increased in 2022. On January 3, 2022, the prime rate was 3.25 percent and had increased to 6.25 percent as of September 22, 2022. Higher interest rates increase the risk that borrowers will default due to an inability to repay, which can lead to charge-offs.

In addition, one of SBA's budgetary goals in FY 2023 is to achieve a zero-subsidy rate for the 7(a) loan program. A zero-subsidy rate occurs when SBA's loan guaranty programs generate sufficient revenue through fee collections and recoveries of collateral on defaulted loans that congressional appropriations are not required to issue new loan guaranties. However, due to program changes, there is a risk that defaults and charge-offs may increase SBA's liability and decrease its ability to achieve its zero-subsidy rate goal.

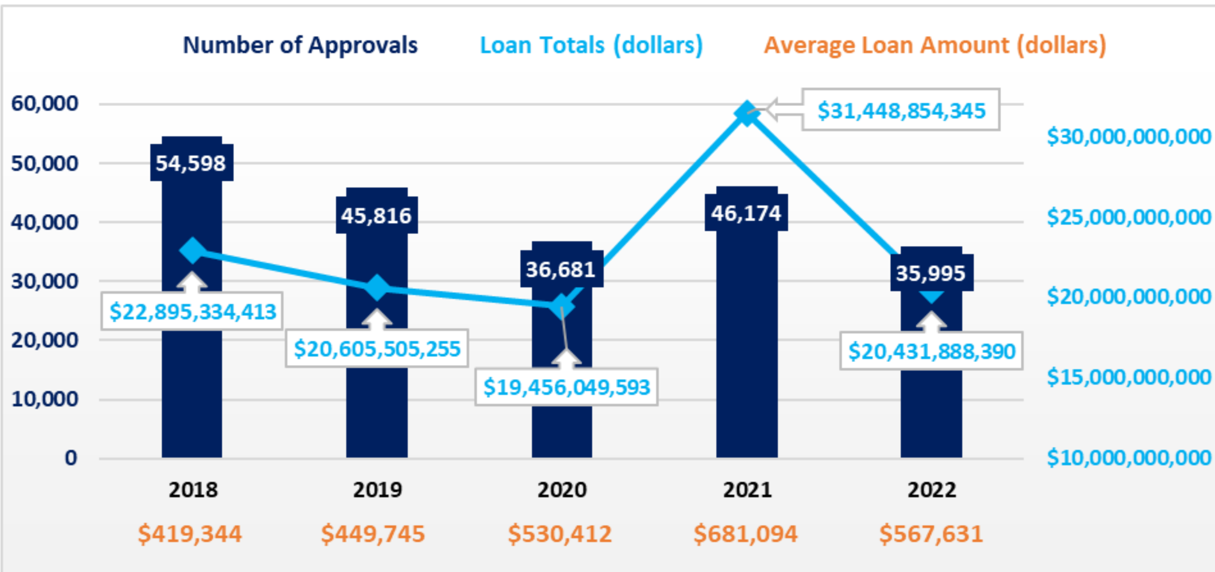
7(a) Loan Program Performance

We reviewed changes in the number of approvals and dollar amounts of 7(a) loans during SBA's pandemic response. The number of 7(a) loans approved and disbursed in FY 2020 decreased from FY 2018 and 2019 levels, returned to FY 2019 levels in FY 2021, and decreased to below FY 2020 totals again in FY 2022.

In FY 2021, the total dollar amount of loans significantly increased to $31.4 billion from $19.4 billion in FY 2020 (62 percent increase) and $20.6 billion in FY 2019 (53 percent increase). In FY 2022, the total dollar amount of loans decreased back to 2019 levels to $20.4 million.

Further, the average loan amount in FY 2021 was $681,094, which was $150,682, or 28 percent, higher than in FY 2020 (see Chart 1). These increases likely occurred because the Economic Aid Act increased SBA's guaranty percentage to 90 percent and eliminated the guaranty fee. Traditionally, the SBA guarantee for 7(a) loans was 75 percent for loans over $150,000 and 85 percent for loans less than or equal to $150,000. In FY 2022, the average loan amount decreased to $567,631, which could be attributable to expiration of the increased guaranty percentage, which ended on October 1, 2021.

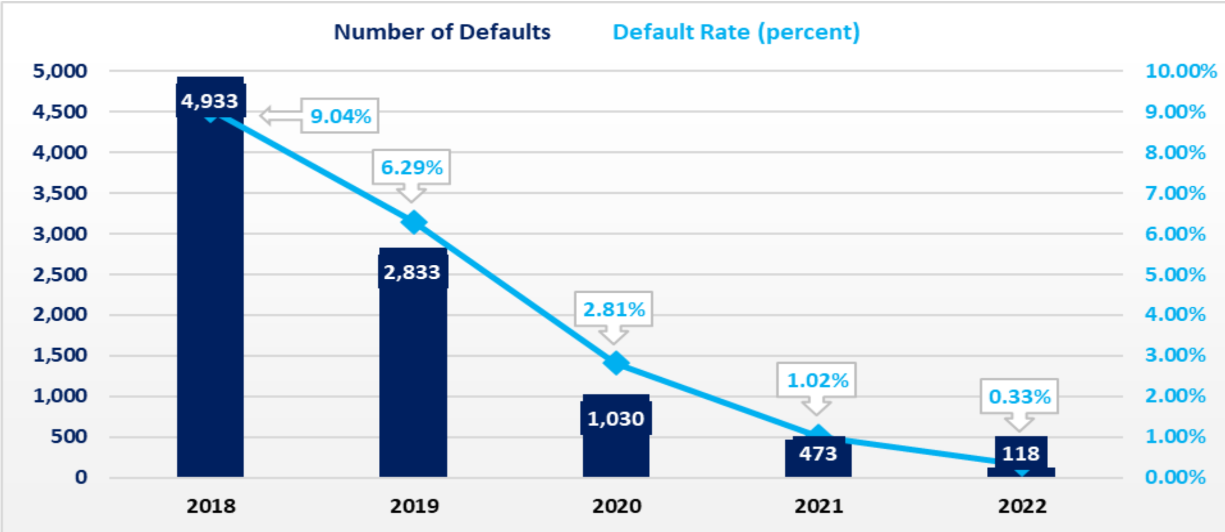
Chart 1: 7(a) Loan Approvals from Fiscal Year 2018 to 2022



Source: SBA OIG analysis

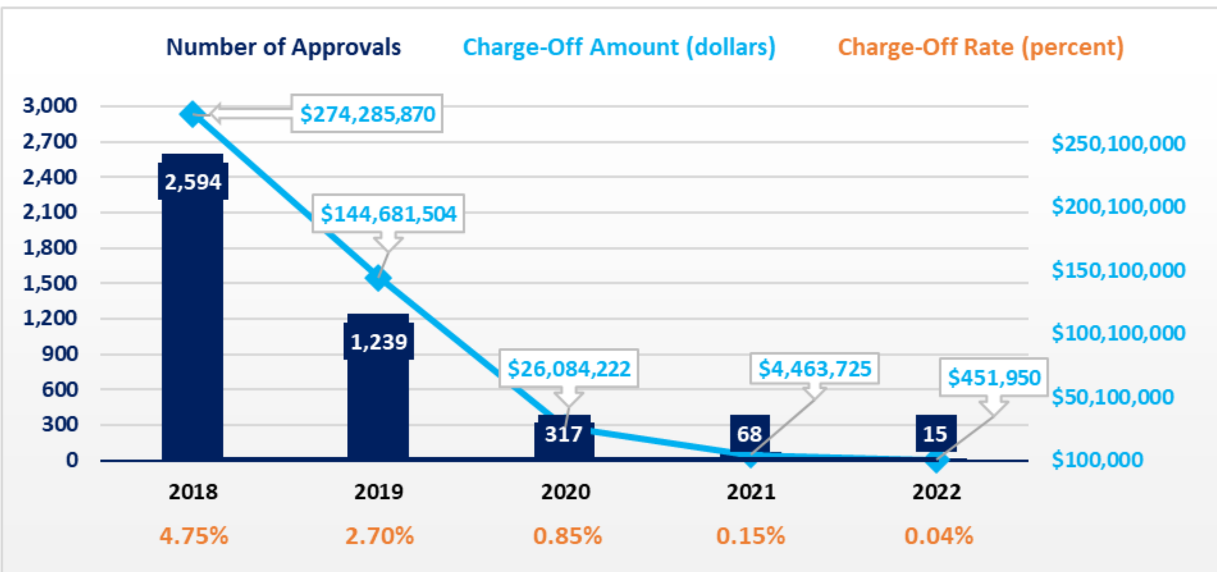
The program performed better in FYs 2020 and 2021 compared to FYs 2018 and 2019. Specifically, the default and charge-off rates were both down compared to the previous years (see Charts 2 and 3). During this time (FYs 2020 and 2021), Section 1112 of the CARES Act provided 6 months of payments on 7(a) loans. In FY 2022, both the default and charge-off rates were still below those of previous years, indicating the assistance provided to 7(a) borrowers during the pandemic was likely effective in preventing some defaults and charge-offs (see Charts 2 and 3).

Chart 2: 7(a) Loan Defaults from Fiscal Year 2018 to 2022



Source: SBA OIG analysis. Data as of February 8, 2023.

Chart 3: 7(a) Loan Charge-Offs from Fiscal Year 2018 to 2022



Source: SBA OIG analysis. Data as of February 8, 2023.

7(a) Loan Program Oversight

According to SBA officials, to address the demands of CARES Act-related requirements, SBA maximized the use of existing staff, increased the use of contractors, conducted streamlined lender reviews, and used existing systems to implement and manage program changes. The SBA Office of Financial Assistance used contractors to help manage its workload in implementing the CARES Act. An SBA Office of Credit Risk Management official stated that during the pandemic, SBA staff turnover and changes affected staff resources for overseeing its 7(a) loan program. The office managed staffing shortages by reassigning staff responsibilities and priorities and offering overtime to meet its lender review requirements.

According to SBA officials, as of August 24, 2022, Office of Credit Risk Management staffing levels decreased from 42 to 26 employees. Office staff oversaw the 7(a) loan program through streamlined lender reviews instead of full scope reviews.[2] This included more desktop and analytical lender reviews, which are limited, data-driven assessments. Full scope reviews include an assessment of loan files and are more comprehensive. In FYs 2020 and 2021, the Office of Credit Risk Management performed 282 and 436 streamlined reviews respectively.

In FY 2020 we reported that the office did not conduct 108 of its 358 planned reviews of high-risk lenders for FYs 2015 to 2017, in part because of limited resources and issues with contract support.[3] The Office of Credit Risk Management plans to conduct 50 full scope reviews in FY 2023. Prior to the pandemic, SBA performed 45 full scope reviews in FY 2019 with significantly more resources than it currently has. The office may need to determine if current staffing levels are appropriate to meet its oversight review goals, which helps ensure lender compliance with 7(a) loan program rules and regulations.

During our exit briefing on March 3, 2023, SBA management generally agreed with our findings and key considerations, stating that they believed the relief payments helped to prevent loan defaults. They also stated the number of employees in the Office of Credit Risk Management increased from 26 to 29 and that SBA was continuing to take actions to address the staffing shortage. Specifically, the Office of Credit Risk Management is recruiting for three job openings, continuing the use of contractors, and using employees assigned on detail. Management stated that as of December 31, 2022, the 7(a) loan program performance metrics were stable and depicted low risk and strong portfolio performance. They acknowledged that the lasting impact of the relief payments, the effects of the higher loan amounts, and rising interest rates were unknown. Management stated they will continue to consider our key considerations in their risk strategy. We considered management’s comments when preparing this final report.

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[2] We relied on the Office of Credit Risk Management’s description of its staffing levels and did not validate staffing levels and related changes.

[3] SBA OIG, 20-03, Audit of SBA’s Oversight of High-Risk Lenders, (November 12, 2019).

Conclusion

Since implementation of the CARES Act in 2020, there are potential risks related to higher loan amounts, rising interest rates, staffing shortages, delayed defaults, and charge-offs which could impact the effectiveness of the 7(a) loan program. To ensure program integrity, reduce risk of financial loss, and facilitate meeting its zero-subsidy rate goal, SBA should consider these risks in its 7(a) loan program risk strategy.

We prepared this white paper in alignment with OIG's quality control standards and the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Federal Offices of Inspector General*, which require that we conduct our work with integrity, objectivity, and independence.

We appreciate the cooperation and courtesies provided by your staff. If you have any questions, please contact me or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6586.

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