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AN EXAMINATION OF THE SMALL BUSINESS ADMINISTRATION'S 7(A) LOANS TO POULTRY FARMERS

HEARING

BEFORE THE

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UNITED STATES
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AN EXAMINATION OF THE SMALL BUSINESS ADMINISTRATION'S 7(A) LOANS TO POULTRY FARMERS

WEDNESDAY, APRIL 18, 2018

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 11:00 a.m., in Room 2360, Rayburn House Office Building, Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Leutkemeyer, Velázquez, and Schneider.

Chairman CHABOT. The Committee will come to order.

The Ranking Member is in another hearing. She will be here after a while, and my understanding is she just wants to submit her opening statement for the record. If she would want to give it we will, of course, give her that opportunity should she wish to do so. And we will probably be joined by additional members from both sides of the aisle here shortly, but we are going to go ahead and get started in the interest of everyone's time.

The mission of the Small Business Administration is to help small businesses compete and succeed in the marketplace. As we have heard many times from small businesses testifying before this Committee, access to capital is one of the biggest challenges small businesses face when starting or expanding their businesses.

To address the financing gap that small businesses can face, the SBA offers the 7(a) loan program for small businesses that have a plan in place for growth but lack the qualifications for conventional lending. SBA offers these small businesses government guaranteed loans through private lending partners.

Recent growth in the program has led to a closer look at the SBA's oversight tools. As a result of multiple hearings, meetings, and briefings, I, along with the Ranking Member, Ms. Velázquez, introduced H.R. 4743, the Small Business 7(a) Lending Oversight Reform Act of 2018. We could not come up with a shorter name. Our Senate counterparts have introduced similar legislation.

By strengthening the SBA's Office of Credit Risk Management and refocusing on the credit elsewhere test, this bicameral and bipartisan legislation aims to ensure the integrity of the program while bringing stability to small businesses that truly require the services of the SBA.

H.R. 4743 and the Senate version unanimously passed through both the House and Senate Small Business Committees in March

of 2018, and I hope they will soon be brought before the both the Full House and the Senate.

The subject of today's hearing is further justification that more oversight of the SBA is needed to ensure that taxpayer dollars are preserved only for small businesses that cannot qualify for traditional lending.

A recent evaluation by the SBA's Office of Inspector General confirmed what the Committee had already suspected; that the SBA may have allowed nearly $2 billion of ineligible guaranteed 7(a) loans to non-small businesses.

The OIG's findings are troubling as it appears that many small poultry farmers were unable to operate their businesses independently, thus violating the SBA's affiliation rules and other regulations.

Today, members will have an opportunity to hear from the OIG about their findings and from the SBA about how the agency intends to implement the OIG's recommendations to ensure that future 7(a) loans meet the statutory, regulatory, and SBA requirements for eligibility.

I appreciate very much the witnesses' testimony here shortly, and we look forward to your testimony.

And again, we will allow the Ranking Member's opening statement to be admitted for the record when she gets here.

And if Committee members have an opening statement prepared, I would ask that they be submitted for the record.

And I will take just a moment to explain the lighting system which is very, I think, yeah, you have both testified. Five-minute rule. The green light will be on for 4 minutes. The yellow light will come on letting you know you have a minute to wrap up, and then the red light will come on to let you know that your time is up. And we would like you to stay within that if at all possible.

Since the Ranking Member got here so fast, it would be appropriate if she would like to, to go ahead and, whenever she is ready, to give her opening statement.

I will yield to the Ranking Member.

Ms. VELAZQUEZ. Thank you so much, Mr. Chairman. And thank you all for being here.

Chicken is America's favorite protein, topping beef and pork for the past 30 years. In 2016 alone, the USDA reported that American farmers raised over 8.8 billion chickens valued at $26 billion for domestic consumption and export. Public demand has resulted in significant changes to the poultry-growing industry.

Where there were once 1.6 million independent farms across the country, a rapid shift to a vertical integration model has resulted in just 25,000 contract farms raising the vast majority of America's poultry.

The very nature of the industry is what brings us here today. Growers need capital to buy firms, build chicken coops, and buy feed to run their operations.

Over the past 4 years, the 7(a) program has experienced significant growth in poultry lending. As noted by the IG's report, SBA has guaranteed over 1,500 poultry loans totaling $1.8 billion from 2012 through 2016.

On the surface, this seems like we are helping small firms get access to capital. However, the nature of these growers' relationship with integrators suggests that loans may not be assisting what most of us consider small businesses.

As we will hear from Mr. Ware, the level of control exercised over the growers is significant, from how to design and build their chicken coops to feeding and watering schedules, integrators have their hands in almost every aspect of a grower's business.

Let's be clear about what is going on here. Large integrators own the chickens, sell the feed to the farmers, dictate the specifications of how to build the grow houses—all while pushing the costs and risk of financing and owning these very capital-intensive structures onto the farmers. Every report I have read, and discussions I have had with stakeholders, indicate there is little in the way of traditional lending to poultry growers. The industry relies almost exclusively on the government guaranteed lending from USDA and SBA used by growers to buy farms, construct chicken houses, and fund operations. This raises serious red flags.

While we all support the SBA program for delivering credit to small businesses that cannot get it elsewhere, it is troubling if the program is being used to displace the growth of a traditional lending market and put taxpayers' money at risk.

I look forward to hearing more from the IG about the details of their report and findings. I am also very interested in hearing from SBA on why they relied on a 1993 regional agency decision based on one contract to determine affiliation, or lack thereof, in these contracts for so long.

Further, I am interested in how the regulatory changes from 2016 are applied to poultry loan applications, and what SBA plans to do to address the affiliation concerns raised by the IG going forward.

Thank you both for being here. Mr. Chairman, I yield back the balance of my time. Thank you.

Chairman CHABOT. Thank you. Thank you very much. The gentlelady yields back.

And I would now like to introduce our distinguished panel here today. Since both have testified here before I am going to keep these relatively short.

Our first witness will be Mr. Hannibal "Mike" Ware, who currently serves as the acting inspector general for the Small Business Administration. The President has nominated him to serve as the permanent inspector general, and both the Senate Small Business and the Homeland Security and Governmental Affairs Committees have favorably reported his nomination to the Full Senate. So congratulations, and hopefully everything will go smoothly for you there, and we look forward to hearing your testimony here today.

And our second witness will be William Manger, who is the associate administrator for the Office of Capital Access at the SBA. One of the programs Mr. Manger's office administers and oversees is the 7(a) loan program. So we also appreciate your testimony and your response to questions here shortly.

So we would now like to turn to Mr. Ware, who is recognized for 5 minutes.

STATEMENTS OF HANNIBAL "MIKE" WARE, ACTING INSPECTOR GENERAL, UNITED STATES SMALL BUSINESS ADMINISTRATION; WILLIAM M. MANGER ASSOCIATE ADMINISTRATOR OFFICE OF CAPITAL ACCESS UNITED STATES SMALL BUSINESS ADMINISTRATION

STATEMENT OF HANNIBAL "MIKE" WARE

Mr. WARE. Thank you, Chairman Chabot, Ranking Member Velázquez, and distinguished members of the Committee. Thank you for the opportunity to be here today and for your continued support of the Office of Inspector General.

We recently published the results of our evaluation of SBA's 7(a) loans made to poultry farmers. We independent initiated this review after speaking with the staff of this Committee, who raised the question about the controlling nature of contracts between large chicken companies, known as integrators, and poultry farmers.

We performed a preliminary assessment and took note of the increases to the size of this segment of the loan portfolio, to the size of these loans, and to the terms of these loans. We subsequently sought to gain an understanding of the operations of this industry and the practical application of SBA's regulations for loans to farmers within the industry. We reviewed Federal laws and regulations, SBA policies and procedures governing the 7(a) loan program, files of performing and defaulted loans, as well as grower-integrator contracts, agreements, and communications.

We further reviewed U.S. Department of Agriculture's loan program guidance, industry-related economic and analytical publications, relevant publications from state university agricultural extensions and publications from industry trade associations. We also reviewed SBA internal communications, guidance, and selected SBA Office of Credit Risk Management lender reviews.

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. The integrators in our sample exercised such comprehensive control over the growers that we believe the concerns appear affiliative on their SBA regulations. Therefore, SBA and lenders approved 7(a) loans that were apparently ineligible under MBA-sized standard regulations and requirements. Specifically, in our review of 7(a) loans made to growers, as well as review of defaulted 7(a) loans to growers, we found integrator-control exercised through a series of contractual restrictions, management agreements, oversight inspections, and market controls. This control overcame practically all of the grower's ability to operate their business independent of integrator mandates. This control was enforced through close integrator oversight, management agreements, and grower-integrator communication.

A grower's failure to comply with these requirements could result in a significant decrease in integrator payments, a reduction in flock placements, or a cancelation of the contract. A grower's economic viability was based upon a performing production contract with an integrator and is the true basis for grower income and facility value. As a result, from fiscal year 2012 to fiscal year 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

To improve SBA's oversight of the 7(a) loan program, we made two recommendations to the associate administrator for the Office of Capital Access. The first, to review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual oversight and market control and take the appropriate corrective actions. And the second, to review the arrangements between integrators and growers under the revised regulations and establish and implement controls, such as supplemental guidance to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

SBA management agreed to both of these recommendations. Both of these recommendations remain open in a resolve status, meaning OIG has agreed to management's plan of corrective action. I am proud of the work performed by our auditors. We certainly appreciate the broader implications of this review on the availability of 7(a) lending resources and on SBA's oversight of the various segments of the loan portfolio.

Thank you for the opportunity to speak to you today, and I look forward to your questions.

Chairman CHABOT. Thank you very much.

Mr. Manger, you are recognized for 5 minutes.

STATEMENT OF WILLIAM M. MANGER

Mr. MANGER. Thank you. Good morning, Chairman Chabot, Ranking Member Velázquez, and members of the Committee. Thank you for the opportunity to speak with you today.

The recent inspector general report examined the agency's poultry loans and lending history. From their examination, two recommendations were issued, both of which SBA has agreed to.

One, SBA was asked to look at 11 loans that served as the sample size and basis of their review; and two, SBA was asked to consider further guidance to ensure that appropriate determinations of affiliation are being made.

The loan activity highlighted by the inspector general occurred over a 5-year period beginning 7 years ago. Having joined the agency in March of 2017, I will need to rely on program office background and data, particularly during the 5-year timeframe.

Before discussing the IG recommendations, it might be helpful to share some data and provide an overview of our lending. Today, our overall 7(a) loan portfolio has a loan count of just over 265,000 loans, and an outstanding balance of $88 billion. Within that, poultry loans represent 1 percent of the entire 7(a) portfolio.

The performance of poultry loans has been very good. These loans have a delinquency rate of .34 percent. This compares favorably to the 7(a) average of .7 percent.

These loans are being made across 32 states and Puerto Rico. The top five states are Mississippi, Georgia, Arkansas, Texas, and North Carolina.

Examples of the types of loan being made include a $600,000 loan to a Kentucky couple who were employed in farming but wanted to start their own business. Another was a $1 million loan in Mississippi to help save a local family-owned, but failing, poultry operation.

The IG report questioned whether the nature of the agreement between the poultry farmer and the business supplying the chicks is so controlling that SBA should consider the two businesses to be affiliated. This concept of affiliation is relevant in determining whether a business is small, because size is determined by aggregating the revenues or employees of the business with those of all of its affiliates.

In the Small Business Act, Congress specifically included agricultural enterprises in the definition of small business. Agricultural enterprises are identified under the NAICS code system as including poultry and egg, forestry and logging, cattle ranching, and hog and pig farming, to name a few.

In our lending, SBA has adhered to longstanding policy guidance that the grower-integrator contract standing alone does not bring about affiliation. In addition, SBA, in 2016, removed from the affiliation regulations the provision that considers contractual relationships that may cause economic dependence of one business on another.

The agency concluded that, in general, only firms that had common ownership or common management should be considered affiliated when determining eligibility for SBA financial assistance. As a result, SBA's current regulations do not consider whether the contract between an integrator and a poultry farmer results in economic dependence when determining the size of the poultry farmer that applies for financial assistance.

Soon after joining the SBA, I began an examination of various loan policies and practices in my office. On issues like franchise agreements, we made changes that were well-received by borrowers, lenders, and other interested parties. We also took action to update our standard operating procedures last fall with several aspects that improve program compliance and ensure prudent lending for all loans, including poultry.

First, we changed some loan terms to a maximum of 15 years, tying that to the useful life of equipment. Second, we provided guidance that our financing is limited to farmland used only in the operation of a business. And third, for businesses with a change of ownership or with startups, we now require at least 10 percent equity.

As we continue to conduct our review of poultry lending, we want to hear from all our stakeholders, and we certainly welcome your views and want to hear from this Committee.

Thank you for the opportunity to testify today. I look forward to working with all of you.

Chairman CHABOT. Thank you very much. I appreciate it.

And I will now lead off the questioning by recognizing myself for 5 minutes. And I will go to you first, Mr. Manger.

What specific steps has the SBA taken since you were made aware of the inspector general findings? I know you discussed that to some degree, but if you could go over those.

Mr. MANGER. Certainly. So we did look at the 11 loans, as requested by the IG's report. In fact, I have a report on the 11 loans. And again, under our evaluation, using the 25-year longstanding policy of the agency, we determined that the contract in place did not create affiliation between the small rural farmer and the inte-

grator, because the ability to profit and bear the risk of loss due to their own efforts was still apparent with the small rural farmer.

Chairman CHABOT. Mr. Ware, let me go to you.

Are you aware of any other industries, either agriculture or otherwise that extend such control over their growers? Are those growers eligible for SBA loans, and do you have any plans to examine any of those loans as well?

Mr. WARE. Our review in this case was specifically to the poultry loans. So we did not look at others, although we came across, of course, the hog industry being one that is kind of close but it was not our intent to review that because of how closely they line up. So we think that the findings of this report could be used by the agency the same way.

Chairman CHABOT. Thank you.

Back to you, Mr. Manger.

Since being made aware of the inspector general's findings, have you provided any guidance for any lenders? Do you intend to publish any kind of guidance or communicate with lenders or their trade associations going forward? Is there any communications effort that you think should be made there?

Mr. MANGER. After the report was released, we did make a statement again that we were reviewing the 11 loans. Upon completion of that review we found that they had been done according to longstanding policy of the agency. We also informed the lenders that, for loans that were made under similar circumstances, in that case we would also honor the guarantee because obviously there was a lot of concern from the lenders that guarantees would not be honored. But we wanted to assure them again that the loans that we looked at, all 11 loans were done properly, and so therefore, the guarantee would be honored.

Chairman CHABOT. Mr. Ware, did your office examine whether or not the credit elsewhere test was being applied properly to lenders? And should some of these growers have been able to qualify for conventional loans or USDA loans?

Mr. WARE. As part of this review, we did not look specifically at the credit elsewhere test. We looked simply based on were they eligible for these types of loans. Eligible for the 7(a) loans.

Chairman CHABOT. Do you think you should have gone and looked at the credit elsewhere?

Mr. WARE. Well, the credit elsewhere test, we have a separate review that is doing that, not only for poultry but across the board. So running in separate lanes but touching everything.

Chairman CHABOT. Mr. Manger, are lenders properly applying the credit elsewhere test before offering 7(a) loans for poultry farming or other related industries as far as you are aware? And why are these growers oftentimes unable to obtain credit elsewhere, particularly when they already have been offered a contract from a large poultry company with a long history in the industry?

Mr. MANGER. No, I appreciate the question. And certainly, Mr. Chairman, credit elsewhere is always something that the agency and my office is looking at because we want to ensure, as the Ranking Member said in her opening statement, we want to make sure that we are making loans available to those that need the capital, that are unable to access the capital conventionally.

Again, our office takes great pains in ensuring that loans are only being made to those that are unable to obtain credit elsewhere. In evaluating the loans, we have looked at them, and again, these people had in their files the proper certification that they were unable to—the lender makes the certification that these lenders would be unable to make the loan without the SBA guarantee. And so that is what we have seen, and again, these loans are to small rural farmers that many times there are not lots of other ways that they can access the capital except through our program.

Chairman CHABOT. Mr. Ware, did you want to comment on that?

Mr. WARE. Yes. I thought I needed to expound quickly on what I said before.

So the basis of this review was their eligibility, and once we ran into the affiliation concerns that in our review were so clear based on the Code of Federal Regulations and what is detailed in there, the credit elsewhere did not become a primary function for us to look into for this particular review.

Chairman CHABOT. Thank you very much. My time is expired.

The Ranking Member is recognized for 5 minutes.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Mr. Manger, you stated in your testimony that the delinquency rates are very low on SBA poultry loans. I think you mentioned .3 percent compared to others, right? So if these loans are such a safe bet, why do they need to have an SBA guarantee? So if you are telling me that they are so good and they make so much sense, why is it that they cannot get a loan through traditional lending?

Mr. MANGER. So Ranking Member, many times these loans are made for the acquisition of land, and in some cases actually the land is quite a large piece of property. And again, the individual does not have the collateral and some of the other prudent lending standards that a conventional loan would be made under in order to acquire not only the property but then to build the broiler houses on the property and all that goes into creating one of these farms. So in those situations, again, the lender makes the determination that they would not be willing to make that loan because of the risk inherent in making the loan unless they have the guarantee provided by the Small Business Administration.

Ms. VELÁZQUEZ. Okay.

Can you tell me, Mr. Manger, what reasons are typically cited by lenders to fulfill the credit elsewhere test to make these loans?

Mr. MANGER. So I would have to get back to you to see exactly——

Ms. VELÁZQUEZ. Well, this is an important issue.

Mr. MANGER. Absolutely.

Ms. VELÁZQUEZ. Because it determines whether or not you are following the law. If you cannot answer me, if you cannot answer this question, how could you tell me that those loans were——

Mr. MANGER. Ma'am, I can tell you that we take the credit elsewhere standards extremely, extremely serious in my office.

Ms. VELÁZQUEZ. But you cannot answer—you cannot give me——

Mr. MANGER. I cannot give you some of the specific——

Ms. VELÁZQUEZ. Thank you.

Mr. MANGER.—examples——

Ms. VELÁZQUEZ. Thank you.

Mr. MANGER.—of what the reasons were.

Ms. VELÁZQUEZ. Okay.

Mr. Ware, the Pew Charitable Trust has also published reports that examine the poultry industry. They stated that government subsidies were a significant driver of the growth we have seen over the past years, 50 years. Did your investigators find many instances of nongovernment-backed lending in the poultry-growth industry?

Mr. WARE. We did not.

Ms. VELÁZQUEZ. Are either of you concerned the growth of SBA involvement in poultry farms is pushing traditional lending out of this market?

Mr. WARE. If I was to answer that, that is probably a viable concern but it was not the focus of our review.

Ms. VELÁZQUEZ. Okay.

So Mr. Manger?

Mr. MANGER. Ma'am, as I stated in my opening statement, this is only 1 percent of the overall 7(a) portfolio representing 1.7 percent of the dollars.

Ms. VELÁZQUEZ. How much dollars?

Mr. MANGER. 1.7 percent of the overall portfolio is in dollars. And that is not crowding out other businesses that need to access capital. The poultry industry is not crowding out——

Ms. VELÁZQUEZ. That is not my concern. My concern is if you comply with the credit elsewhere test. That is my concern.

Mr. MANGER. And I can give you one reason probably why a lot of these loans were made this way, because many of the loans were given a longer term than a conventional loan would offer, and that is one reason in credit elsewhere where we allow for an SBA loan to be made because the ability to repay the loan by the small farmer needs a longer term and it would not be available in a conventional loan. It is only available in an SBA loan. So that is one of the reasons in credit elsewhere why these loans would be eligible because in some instances the term of the loan was up to 21 years.

Ms. VELÁZQUEZ. So let me ask you this question.

Mr. MANGER. Yes.

Ms. VELÁZQUEZ. Should there be similar requirements aligning contract length with poultry loan length to protect the farmers and taxpayers?

Mr. MANGER. As a matter of fact, I will just restate what we did in the SOP that became effective on January 1st of this year. We have now limited the term of the loan to 15 years, tying that to the life of the useful equipment. In this case it would be the broiler houses. That was not the case before January 1st of this year. We also have now limited the amount of farmland that can be acquired only to the farmland that is necessary for the specific business. We found in some instances additional farmland was being acquired. We do not allow that except for what is necessary with the specific operation.

And finally, and importantly, to talk about the risk, we are now requiring for a change of ownership or a start-up—many of these poultry businesses were start-ups—we are now requiring a 10 per-

cent equity injection from the borrower. That is equity coming from the borrower, not from the taxpayer.

Chairman CHABOT. The gentlelady's time has expired. Does she need an additional minute? Or we can go to a second round if you like.

Ms. VELÁZQUEZ. Yes.

Chairman CHABOT. All right. We will probably go to a second round.

The gentleman from Missouri, the Vice Chairman of this Committee is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

It would seem to me that the discussion today centers around the difference between a franchise and an affiliate.

Mr. Ware, can you explain to me at the very essence here what your definition of affiliate is and why you believe that these farms do not comply?

Mr. WARE. Sure. Thanks for the question.

So the OIG does not have a problem necessarily with the relationship between a franchise or a franchisee as long as the contracts are not controlling by the franchiser.

Mr. LUETKEMEYER. Well, what is your definition of controlling? I mean, because every franchise controls its franchisee to a certain extent. It depends on whether you are talking about an auto dealer, or you are talking about McDonald's, or are you talking about Cargill or Tyson? Those folks all have control over the people that are doing business.

Mr. WARE. Correct, sir. However, if the control is comprehensive, by rule and by the law, it is so comprehensive that it——

Mr. LUETKEMEYER. Well, what is your definition of comprehensive?

Mr. WARE. Comprehensive means—so it is not every franchise that will qualify for a Small Business Administration loan. My definition——

Mr. LUETKEMEYER. Do you make loans to McDonald's? Do you make loans to car dealerships?

Mr. WARE. I am not certain exactly who the SBA makes loans——

Mr. LUETKEMEYER. Mr. Manger, do you make loans to car dealers and McDonald's franchise folks?

Mr. MANGER. We have just started making loans available to car dealerships.

Mr. LUETKEMEYER. Okay.

Mr. MANGER. As we have reviewed——

Mr. LUETKEMEYER. Does anybody know the business model of a car dealership? There is nobody that is controlled more than a car dealership by their company.

Mr. WARE. I would suggest that from our vantage point, based on our review on poultry loans, right, that if that is controlling to the point where even the very specifications of your broiler house is controlled, when you can walk into your broiler house is controlled, where you can walk in your broiler house is controlled, when the chicks are fed, when they are given medicine is controlled, and if you do not adhere to anything you can lose your flock

placement, you can lose your flock and that automatically will cause you to default, that is controlling.

Mr. LUETKEMEYER. Mr. Ware, you are talking to somebody who has got millions of turkeys growing in his district.

Mr. WARE. Yes.

Mr. LUETKEMEYER. I know exactly what you are talking about. And the reason that they do this, because those birds are not owned by the individual.

Mr. WARE. Correct.

Mr. LUETKEMEYER. Those birds are owned by the company that puts them in there and they require certain things. Just like if you were building a building. If you are the contractor, the owner says I want this building built a certain way. I need these kinds of materials and I want it built a certain way. I am going to have the architect to make sure that it stays there. These buildings and these birds, there is a model, a business model that they want you to, just like any other franchise, with McDonald's, or whether it is a Ford dealership, there is a certain level of integration of all of the different requirements that the franchise wants you to, as a franchisee, to put into your business model.

The thing that concerns me here is you are forgetting about the rest of this business model. These people do not raise just turkeys and chickens. They also normally have a cattle operation affiliated with this because they normally have enough land to spread the manure out, which is a commodity that is an inexpensive way to fertilize your farm and they will have an integrated cattle operation as well. And that is usually financed separately from this.

So the answer to the Ranking Member's question a while ago, the reason that these farmers come to SBA for this is usually they are highly leveraged. They are trying to get a new building, buy a new farm next to them, and they cannot get this financing because of the amount of debt they are incurring because of the size of these buildings, which are several hundred feet long. So I am trying to figure out here how you can get to this affiliated definition whenever you have got so many other businesses out here that are franchise operations that are much more controlled by the franchise company than what these folks are because I know this model.

Mr. WARE. Can I answer?

Mr. LUETKEMEYER. Absolutely. I am looking forward to your answer, sir.

Mr. WARE. We do not have an issue with any of those things. What we have issue with is that by definition, by the code, by the CFR, they are not considered small. So from our——

Mr. LUETKEMEYER. Okay. What is your definition of small then?

Mr. WARE. Well, the CFR, in particular, concerning this with affiliation again goes back to such comprehensive control that management agreements is the exact term that is used in there.

Mr. LUETKEMEYER. They do not control the entire operation though, Mr. Ware. That is what I am trying to get at. They control only the poultry part of this operation. The operation may be several hundred acres with several hundred head of cattle on it.

Mr. WARE. But that is now what the Small Business Administration would be putting their guarantee for.

Mr. LUETKEMEYER. They are guaranteeing the land and the poultry buildings that are on there. The real estate and buildings. You are not guaranteeing the operation. The operation is completely different.

Mr. WARE. Well, Congressman, when these contracts, these same contracts that they are guaranteed, when the flock placement is not right and the flock placement goes away, so does the loan. And here comes the guaranty.

Mr. LUETKEMEYER. Mr. Ware, if I have got a car dealership and I am not meeting my quotas, do you know what happens? I lose my franchise. I have got to sell X number of units per month; otherwise, at the end of the month I am going to get a few more from the company who says now you have got another 30 days to sell those on top of it or else.

Mr. WARE. But I am not sure your car dealership qualifies as a small business.

Mr. LUETKEMEYER. Mr. Manger said they are starting to do that now.

Mr. WARE. And we would like to take a look at that.

Mr. LUETKEMEYER. I mean, I could go through a whole list of franchise companies and we can talk about this all day, but my concern is that I think we are losing, we are nitpicking on this affiliate definition. I am not sure you really understand the business model of what a poultry farmer really is all about.

Mr. WARE. I do understand the business model pretty well. I do understand it, and I am saying that that business model makes it affiliative by nature.

Mr. LUETKEMEYER. My time is expired.

Chairman CHABOT. The gentleman's time is expired.

Since we have a relatively few number of members here today, we are going to go to a second round.

I have just got one or two questions myself and then I am going to turn it over to the other members that are here.

My question is this. I note that the terms for poultry loans over the last few years have been getting longer, going up to 20 years; whereas, the contracts oftentimes are relatively short. In fact, your flock, my understanding is 5 to 9 weeks or so. And I think if one of these small farmers, you know, goes out of business or whatsoever, if the contract is not renewed, it can be a pretty tough business to sell and you may get 6 percent on what you invested, the other 94 percent going away. So it is pretty challenging.

So would both of you comment on the lengthening of these loans and the short period of the contract? And would the small business farmer in this case not be better protected if the contracts, if that is something you took into consideration, that they were longer, so they had more of an assurance that they could remain in business for a longer time to support their time?

Mr. Manger?

Mr. MANGER. Sure, Mr. Chairman.

So the regulations stipulate that the lender must evaluate the ability of the borrower to repay the loan. In some of the instances, specifically on the 11 loans that were analyzed, there was also the

purchase of land involved. It was not solely for the construction of broiler houses. For the purchase of land, many times it would be necessary to a small rural farmer to be able to extend those payments out for a longer period of time in order to be able to acquire the property. So it is not solely based on contracts that the individual may have or the business may have. It is based on, again, their ability to repay the loan. And in this instance, in the loans I am citing with the acquisition of property, that is really the main reason why such a long term was needed on the loan.

It also does not control what other businesses the small business may enter into. As was said earlier by Congressman Luetkemeyer, many times they would have a portion of the property maybe be for poultry, but they could be involved in other enterprises on other parts of the property, whether it be manure harvesting or other ventures. So again, it is not so reliant only on this one contract, especially in the acquisition of property and the lender must again certify that the borrower has the ability to repay the loan.

Chairman CHABOT. Thank you.

Mr. Ware, did you want to comment on that at all?

Mr. WARE. Sure. Yes. I need to comment on it because when the agency is giving loans to poultry farmers, it is for that purpose. In the defaulted loans that we reviewed, when the contracts went away, so did the poultry farm. So I think that is a very vital piece of whatever review would be made, and I believe that in the industry, from what I have studied, in the industry they are moving toward their contracts in terms of the integrator and the farmers as being a little bit longer because of more conventional lending methods that are out there and that is the only way that they would qualify for those.

Chairman CHABOT. Thank you very much. I am going to yield back.

The Ranking Member is recognized for 5 minutes.

Ms. VELÁZQUEZ. Mr. Manger, I heard you talk about some of the changes about excess land equity injection, those issues have nothing to do with the affiliation issue. I know that you were not there in July 2016 when the IG presented its report, but I would just like to ask you, who signed off on the changes that were made, particularly knocking out the economic dependence of business contract affiliation? Who did that?

Mr. MANGER. That was done by the previous administration. I am not sure if it was signed off by the person that had the associate administrator position in Capital Access or——

Ms. VELÁZQUEZ. Can you get back to us?

Mr. MANGER. Yes.

Ms. VELÁZQUEZ. Okay.

Mr. MANGER.—or possibly the administrator at the time.

Ms. VELÁZQUEZ. Well, if those changes were made, I would like to know who signed off on accepting those changes because this is a very important issue, the issue of affiliation, and if I have to introduce legislation to go to the original affiliation issue, I am going to do that. Okay?

Thank you, Mr. Chairman.

Chairman CHABOT. The gentlelady yields back.

We have one other member who we thought was on his way but in light of the fact that he is not here I think we are going to wrap up this hearing.

We appreciate the gentlemen giving their testimony here this morning.

An important industry, there are obviously some questions here we would ask our Committee staff to continue to work with the SBA to make sure that all the appropriate regulations and the loans that are being made are being made in a proper manner and that the dollars that we have available are going to actually help small businesses and the families that they support. So we will continue to follow this topic.

I would ask unanimous consent that members have 5 legislative days to submit statements and submit supporting materials for the record.

Without objection, so ordered.

If there is no further business to come before the Committee, we are adjourned. Thank you.

[Whereupon, at 11:46 a.m., the Committee was adjourned.]

APPENDIX

STATEMENT OF

HANNIBAL "MIKE" WARE
ACTING INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

APRIL 18, 2018

INTRODUCTION

Chairman Chabot, Ranking Member Velázquez, and distinguished members of the Committee, thank you for the opportunity to be here today and for your continued support of the Office of Inspector General (OIG). We recently published the results of our audit of the Small Business Administration's (SBA's) evaluation of 7(a) loans made to poultry farmers. I am happy to discuss our findings with you today.

OIG's ROLE

OIG was established within SBA by statute to promote economy, efficiency, and effectiveness and to deter and detect waste, fraud, abuse, and mismanagement in the Agency's programs and operations. During fiscal year (FY) 2017, OIG achieved over $82 million in monetary recoveries and savings and made 72 recommendations for improving SBA's operations and reducing fraud and unnecessary losses in the Agency's programs.

OIG audits are conducted in accordance with Federal audit standards established by the Comptroller General, and other reviews generally are conducted in accordance with standard established by the Council of the Inspector General on Integrity and Efficiency (CIGIE). In addition, we coordinate with the Government Accountability Office to avoid duplicating Federal audits. We also establish criteria to ensure that the non-Federal auditors that OIG uses (typically, certified public accountant firms) comply with Federal audit standards.

OIG's EVALUATION OF 7(A) LOANS MADE TO POULTRY FARMERS

OIG report 18-13, titled *Evaluation of SBA 7(a) Loans Made to Poultry Farmers* presents the results of our review of loans made to poultry farmers under SBA's 7(a) Loan Program. The 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses, offering financing guarantees for loan amounts up to $5 million to fund startup costs, expand existing businesses, purchase equipment, repair existing capital, and other uses. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. Some 7(a) loans are made by lenders using delegated authority, which undergo limited review by SBA prior to loan disbursement. Other 7(a) loans are subject to more extensive underwriting and eligibility review and approval by SBA before the loan is disbursed.

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met statutory, regulatory, and SBA requirements for eligibility. To accomplish our objective we reviewed Federal laws and regulations, SBA policies and procedures governing the 7(a) Loan Program, files of performing and defaulted loans, as well as grower-integrator contracts, agreements, and com-

munications. We further reviewed U.S. Department of Agriculture's (USDA) loan program guidance, industry-related economic and analytic publications, relevant publications from state university agricultural extensions, and publications from industry trade associations. We also reviewed SBA internal communications, guidance, and selected SBA Office of Credit Risk Management lender reviews.

We interviewed officials and staff from the SBA Office of Capital Access, SBA Office of General Counsel, USDA Economic Research Service, USDA National Agricultural Statistics Service, USDA Farm Service Agency, USDA Office of Rural Development, and the USDA Office of Inspector General. We also interviewed executives and loan officers at various lending institutions, certified assessors, integrators, and growers.

We analyzed the population of 7(a) loans made to agricultural enterprises, and to the agricultural subset of poultry farmers, to obtain an understanding of the SBA loan portfolio, and its characteristics, for FYs 2012 through 2016. This population was limited to approved regular 7(a), Certified Lender Program, and Preferred Lender Program loans. Further, for this analysis, we defined agricultural enterprises to include North America Industry Classification System (NAICS) codes 111110 through 114210. The subset of poultry farmers was defined with NAICS codes 112320 and 112390. From this population, we judgmentally selected a sample of 11 loans; this sample was populated by loans at either the median size or the largest size for its fiscal year. We used this sample to guide a review of loan files, grower contracts, and grower-integrator communications, and interview parties to these loans, Further, we reviewed a sample of defaulted poultry loans to understand the degree to which integrator contracts affect facility value.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections; present all factual data accurately, fairly, and objectively; and present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objective.

What OIG Found

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. SBA requirements state that the small business applicant must be small under SBA size standards. The applicant combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant or the primary industry of the applicant and its affiliates, whichever is higher.

The large chicken companies (integrators) in our sample exercised such comprehensive control over the growers that the SBA Office of Inspector General believes the concerns appear affiliative under SBA regulations. Therefore, SBA and lenders approved 7(a) loans that were apparently ineligible under SBA size standard regulations and requirements. Specifically, in our review of a sample

of 11 7(a) loans made to growers, as well as review of defaulted 7(a) loans to growers, we found integrator control exercised through a series of contractual restrictions, management agreements, oversight inspections, and market controls. This control overcame practically all of a grower's ability to operate their business independent of integrator mandates. A grower's failure to comply with these requirements could result in a significant decease in integrator payments, a reduction in flock placements, or a cancellation of the contract. A grower's economic viability was based upon a performing production contract with an integrator and is the true basis for grower income and facility value. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

OIG Recommendations

To improve SBA's oversight of the 7(a) Loan Program, we recommended the Associate Administrator for the Office of Capital Access (1) review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s), and (2) review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

Agency Response

SBA management agreed with both recommendations made by OIG. Regarding Recommendation 1, SBA will perform a review of the loans cited in the evaluation to determine whether SBA loan specialists and lenders made proper size determinations. For Recommendation 2, SBA will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, SBA will establish additional controls to ensure SBA loan specialists and lenders make the appropriate affiliation determinations.

CONCLUSION

I am proud of the work performed by our auditors to raise awareness of this growing segment of SBA's 7(a) loan portfolio. In performing this work, they obtained a deep understanding of the operations of this industry and the practical application of SBA's regulations for loans to farmers within the industry. We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. Integrators were ineligible to participate in the SBA 7(a) Loan Program due to their size; however, integrators exercised such comprehensive control over the growers that the SBA OIG believes the concerns were affiliated. Therefore, SBA and lenders approved 7(a) loans to growers that appear ineligible under SBA size standard regulations and requirements.

OIG will continue to provide independent, objective oversight to improve the integrity, accountability, and performance of the SBA and its programs for the benefit of the American people. Our focus is to keep SBA leadership, our congressional stakeholders, and the public currently and fully informed about the problems and deficiencies in the programs as identified through our work. We value our relationship with the Committee and the Congress at large, and we look forward to working together to address identified risks and the most pressing management challenges facing SBA.

William Manger

Associate Administrator

Office of Capital Access

U.S. Small Business Administration

House Committee on Small Business

Examination of 7(a) Loans to Poultry Farmers

April 18, 2018

Thank you, Chairman Chabot and Ranking Member Velazquez. I appreciate the opportunity to talk to you about poultry loans and the Agency's 7(a) lending history.

The March 2018 Inspector General report examined loans made to poultry growers during Fiscal Year 2012 to Fiscal Year 2016. From their examination, the IG issued two recommendations to the Agency, both of which SBA agreed with.

First, SBA was asked to look at eleven loans that served as the sample size and basis of the Inspector General's review. Second, SBA was asked to consider further guidance to ensure that appropriate determinations of affiliation are being made.

The loan activity highlighted by the Inspector General occurred over a five year span, beginning seven years ago. I came on board at the Agency to lead the Office of Capital Access in March of 2017. Accordingly, for questions about the Agency's poultry loan history, particularly during that five year timeframe, I will need to rely on program office background and data.

Before getting to the two IG recommendations, let me give you a general overview of lending in our 7(a) program, both past and present.

Today, our overall 7(a) loan portfolio – all categories – has a loan count of just over 265,000 loans (265,014) and an outstanding balance of $88.1 billion.

Within that, poultry loans represent just 1% of the entire 7(a) portfolio. During the FY2012 to FY2016 period, the number of poultry loans approved by lenders and SBA totaled 2,201, with a corresponding value of $1.88 billion.

The average approved amount of poultry loans ranged from $521,000 in FY2012 to just over $1 million in FY2016.

The performance of poultry loans has been very good. Those loans have a delinquency rate of less than one-half of one-percent (0.34%). This compares to the 7(a) average of 0.64%.

Examples of the type of loans made during this time are of a $600,000 loan to a Kentucky couple who were employed in farming but wanted to start their own business, and a $1 million loan in Mississippi to save a local family owned, but failing, poultry operation.

With that as a foundation, let's turn to the two IG recommendations and SBA's response. As mentioned, we were asked to look at the eleven loans cited in the evaluation sample and, more generally, at the arrangements between integrators and growers. As Associate Administrator for Capital Access, I was asked to determine if our staff, and lenders, made a proper size determination on the eleven loans. If not, it was recommended that we take corrective action.

Soon after the release of the IG report, my office reviewed the eleven loans and found that the loans were properly made, in accordance with SBA policy and procedure at the time. We are also reviewing the arrangements between integrators and growers and will determine whether

supplemental guidance is needed to ensure that appropriate affiliation determinations continue to be made.

The IG report questioned whether the nature of the agreement between the poultry grower and the business supplying the chicks is so controlling that SBA should consider the two businesses to be affiliated. This concept of affiliation is relevant in determining whether a business is small because the size of a business is determined by aggregating the revenues or employees of the business with those of all of its affiliates. As you know, only businesses that are small are eligible for financial assistance under SBA's general business loan programs.

In accordance with the Small Business Act, SBA makes financial assistance available to certain poultry farmers and other agricultural enterprises. Although it is the mission of the Department of Agriculture to assist farm businesses in rural America, Congress also specifically included agricultural enterprises in the definition of small business for purposes of SBA's general business loan programs. Agricultural enterprises are identified under the NAICS code system as including poultry and egg; forestry and logging; cattle ranching; and hog and pig farming, to name a few.

As the IG report noted, SBA has taken the position for many years that the poultry grower-integrator contract, standing alone, does not bring about affiliation. Recently, in the last Administration, the SBA rules governing affiliation in the business loan programs were narrowed. The Agency removed from the affiliation regulations the provision that considers contractual relationships that may cause economic dependence of one business on another.

The Agency concluded that, in general, only firms that had common ownership, or common management, should be considered affiliated when determining eligibility for SBA financial assistance. As a result, SBA's current regulations do not consider whether the contract between an integrator and a poultry farmer results in economic dependence when determining the size of the poultry farmer that applies for financial assistance.

The Office of Capital Access is currently evaluating our policies to determine if any modifications are needed. Soon after joining the SBA, I began an examination of various loan policies and practices in my office. As an example, on the topic of franchise lending, we ultimately implemented changes that were incorporated into the program last year, all of which have been well received by borrowers, lenders and other interested parties. As we continue to conduct our review of poultry lending, we want to hear from all stakeholders, and I would certainly welcome the views of this Committee and your Senate counterparts. If, for this specific area of lending, modified policy guidance is appropriate, then we would want to shape that with your input.

Thank you for the opportunity to testify today. I look forward to working with you.

EVALUATION REPORT

EVALUATION OF SBA 7(A) LOANS MADE TO POULTRY FARMERS

MARCH 6, 2018 REPORT NUMBER 18-13

EXECUTIVE SUMMARY

EVALUATION OF SBA 7(A) LOANS MADE TO POULTRY FARMERS

Report No. 18-13

March 6, 2018

What OIG Reviewed

This report presents the results of our evaluation of the Small Business Administration's (SBA's) 7(a) loans made to poultry farmers. The 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses, offering financing guarantees for loan amounts up to $5 million to fund startup costs, expand existing businesses, purchase equipment, repair existing capital, and other uses. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. Some 7(a) loans are made by lenders using delegated authority, which undergo limited review by SBA prior to loan disbursement. Other 7(a) loans are subject to more extensive underwriting and eligibility review and approval by SBA before the loan is disbursed.

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met statutory, regulatory, and SBA requirements for eligibility.

What OIG Found

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. The large chicken companies (integrators) in our sample exercised such comprehensive control over the growers that the SBA Office of Inspector General believes the concerns appear affiliative under SBA regulations. Therefore, SBA and lenders approved 7(a) loans that were apparently ineligible under SBA size standard regulations and requirements. Specifically, in our review of a sample of 11 7(a) loans made to growers, as well as review of defaulted 7(a) loans to growers, we found integrator control exercised through a series of contractual restrictions, management agreements, oversight inspections, and market controls. This control overcame practically all of a grower's ability to operate their business independent of integrator mandates.

This control was enforced through close integrator oversight, management agreements, and grower–integrator communication. A grower's failure to comply with these requirements could result in a significant decrease in integrator payments, a reduction in flock placements, or a cancellation of the contract. A grower's economic viability was based upon a performing production contract with an integrator and is the true basis for grower income and facility value. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

OIG Recommendations

To improve SBA's oversight of the 7(a) Loan Program, we recommended the Associate Administrator for the Office of Capital Access (1) review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s), and (2) review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

Agency Response

SBA management agreed with both recommendations. Regarding Recommendation 1, SBA will perform a review of the loans cited in the evaluation to determine whether SBA loan specialists and lenders made proper size determinations. For Recommendation 2, SBA will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, SBA will establish additional controls to ensure SBA loan specialists and lenders make the appropriate affiliation determinations.

In its final response, SBA noted the report inaccurately stated loans made by the delegated lenders undergo a limited review by SBA prior to disbursement. SBA further suggested we change the statement for accuracy. However, the information stated in the report is an accurate depiction from SBA's SOP 50 10 5, which states that such loans receive a brief eligibility review. In subsequent correspondence, SBA clarified the limited reviews cited in their policy are automated via SBA's electronic loan intake system.

U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Final Report Transmittal
Report Number: 18-13

DATE: March 6, 2018

TO: Linda E. McMahon
Administrator

FROM: Hannibal "Mike" Ware
Acting Inspector General

SUBJECT: *Evaluation of SBA 7(a) Loans Made to Poultry Farmers*

This report presents the results of our evaluation of the Small Business Administration's (SBA's) 7(a) loans made to poultry farmers. Our objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility.

We considered management comments when preparing this final report. Management agreed with both recommendations.

We appreciate the courtesies and cooperation extended to us during this evaluation. If you have any questions, please contact me at (202) 205-6586 or Andrea Deadwyler, Assistant Inspector General for Audits, at (202) 205-6616.

cc: Althea Coetzee Leslie, Deputy Administrator
Pradeep Belur, Chief of Staff
William M. Manger, Associate Administrator, Office of Capital Access
John Miller, Deputy Associate Administrator, Office of Capital Access
Christopher Pilkerton, General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Timothy E. Gribben, Chief Financial Officer and Associate Administrator for Performance Management
LaNae Twite, Director, Office of Internal Controls

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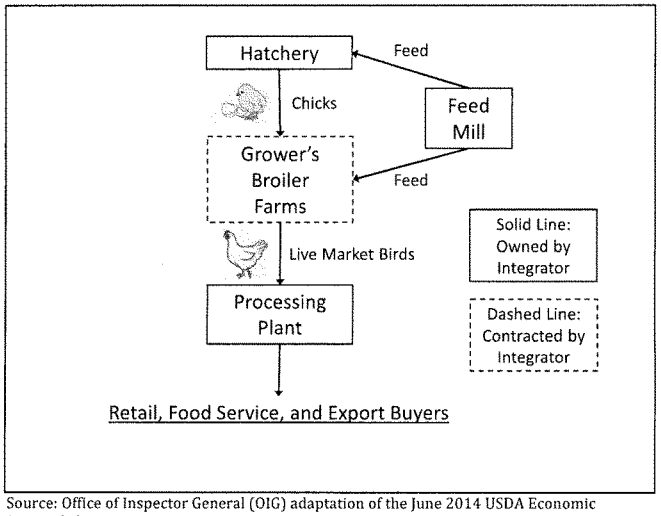
Introduction

Commercial Chicken Farming

The majority of chickens raised commercially in the United States are broilers: young chickens bred for meat production. With a 2016 market value of $25.9 billion, broilers are raised almost entirely by poultry farmers (growers) that operate under exclusive contracts with large chicken companies (integrators).[1]

The broiler industry's structure is vertically integrated, and production and processing is tightly controlled by the integrators. In this structure, integrators own and operate the hatcheries and deliver flocks of chicks to contract growers, which own the broiler housing and provide the utilities and labor to raise the flocks to market weights. The integrators pay contract fees to the growers and supply feed, veterinary services, technical supervision, and flock transportation. After 5–9 weeks, depending on bird size, live market birds are shipped from grower farms to the integrator's processing plant for slaughter and marketing. The following figure, adapted from a June 2014 United States Department of Agriculture (USDA) Economic Research Service report, illustrates the relationship between the integrators and growers within the broiler industry.[2]

Figure 1: Relationship of Integrators and Growers Within the Broiler Industry



Source: Office of Inspector General (OIG) adaptation of the June 2014 USDA Economic Research Service report.

[1] USDA National Agricultural Statistics Service, *Poultry – Production and Value 2016 Summary*, ISSN: 1949-1573, April 2017.
[2] USDA Economic Research Service, *Technology, Organization, and Financial Performance in U.S. Broiler Production*, EIB-126, June 2014.

Growers make substantial and long-lived investments to construct, operate, maintain, and periodically upgrade their broiler houses. These houses are special-purpose properties that have little value without a performing production contract with an integrator. Therefore, the integrator contract is the true economic value of a grower's facility.

The broiler industry relies almost exclusively on production contracts. Further, according to a 2016 report prepared for the National Chicken Council, the majority of broiler production contracts were for less than 1 year. Specifically, 42 percent of growers were contracted on a "flock-to-flock" basis, where the integrator made no specific commitment to provide chicks beyond the current flock's placement; an additional 11 percent of growers were on contracts of less than 1 year.[3]

In addition, the local market for growers is highly concentrated. According to the June 2014 USDA Economic Research Service report, 21.7 percent of growers reported that there was only a single integrator in their area, and another 30.2 percent reported two integrators in their area. Together, the growers in these markets accounted for approximately 57 percent of broiler production in the United States.

The growers' facilities are usually financed through borrowing from commercial banks or the Farm Credit System. Growers used Federal guarantees for poultry loans obtained through the U.S. Small Business Administration (SBA) 7(a) Loan Program, and the USDA Farm Service Agency.

SBA's 7(a) Loan Program

The 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. The 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses, offering financing guarantees for loan amounts up to $5 million to fund startup costs, expand existing businesses, purchase equipment, repair existing capital, and other uses. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules and regulations. Some 7(a) loans are made by lenders using delegated authority; these loans undergo limited review by SBA prior to loan disbursement. Other 7(a) loans are subject to more extensive underwriting and eligibility review and approval by SBA before the loan is disbursed.

SBA requirements state that the small business applicant must be small under SBA size standards. The applicant combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant or the primary industry of the applicant and its affiliates, whichever is higher.

Significant Changes in the Characteristics of SBA's 7(a) Poultry Loan Portfolio

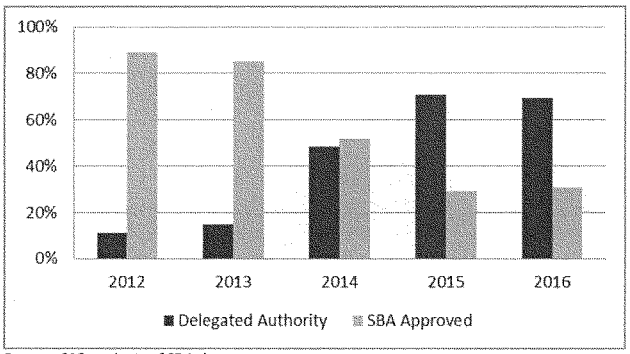
From fiscal year (FY) 2012 to FY 2016, SBA guaranteed 1,535 7(a) loans, totaling approximately $1.8 billion, that were approved and disbursed to businesses operating within the poultry grower industry. Over this time and as described below, the characteristics of SBA's poultry loan portfolio changed significantly. The population for this analysis is defined in Appendix I.

[3] FarmEcon LLC, *Live Chicken Production Trends*, April 26, 2016.

Delivery Method

The share of 7(a) poultry loans approved by lenders under delegated authority grew sharply. In FY 2012, SBA approved 89 percent of 7(a) poultry loans, with the remaining 11 percent made by lenders under their delegated authority. By FY 2016, however, SBA directly approved 31 percent, with the clear majority of loans—69 percent—being made by lenders under their delegated authority (see Figure 2).

Figure 2: Change in Delivery Method for 7(a) Poultry Loans, FY 2012-2016

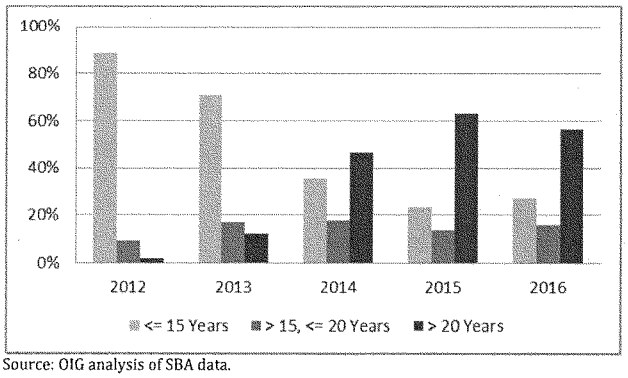


Source: OIG analysis of SBA data.

7(a) Loan Terms

Moreover, as delegated authority became more common, the maturity terms of the poultry loan portfolio also changed substantially. In FY 2012, 89 percent of the approved loan value matured in 15 years or less, while only 2 percent had maturities greater than 20 years. In FY 2016, however, 57 percent of the approved loan dollars had maturities greater than 20 years (see Figure 3).

Figure 3: Change in 7(a) Poultry Loan Terms, FY 2012-2016

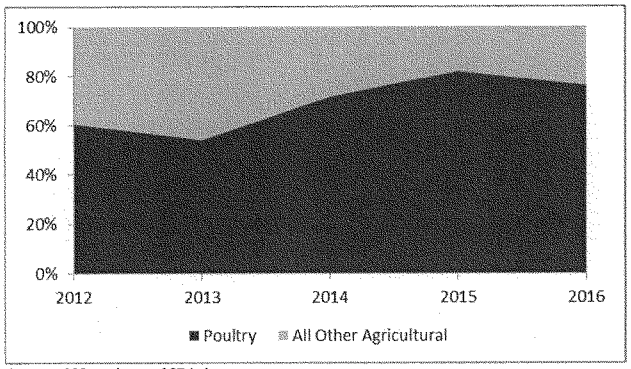


Source: OIG analysis of SBA data.

7(a) Agricultural Loans

Although poultry loans have accounted for the largest portion of 7(a) agricultural loans, poultry's share has grown over time. Poultry's portion increased from 61 percent of all 7(a) agricultural loans in FY 2012 to 76 percent in FY 2016 (see Figure 4).

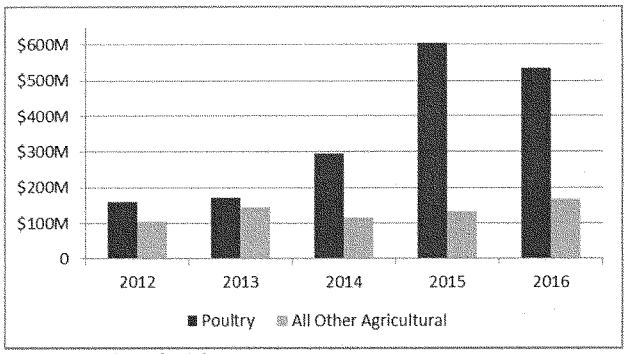
Figure 4: Proportion of Poultry Loans of All 7(a) Agricultural Loans, by Value, FY 2012–2016



Source: OIG analysis of SBA data.

In addition to these changes, key measures for loan values of SBA's portfolio of 7(a) poultry loans also has changed significantly. For example, the value of 7(a) poultry loans originated in a fiscal year increased 235 percent, from $159 million in FY 2012 to $534 million in FY 2016. For comparison, the value of all other 7(a) agricultural loans increased 62 percent (see Figure 5).

Figure 5: Annual Value of 7(a) Poultry Loans to Other 7(a) Agricultural Loans, FY 2012–2016

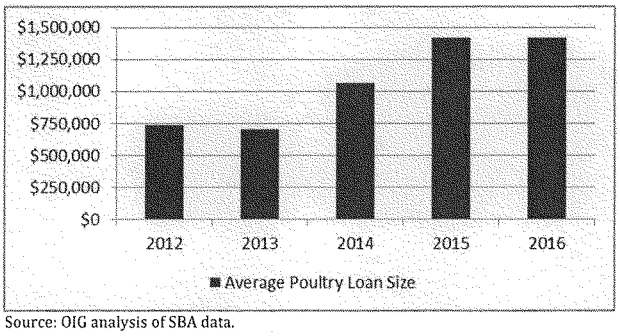


Source: OIG analysis of SBA data.

7(a) Poultry Loan Size and Lenders

Additionally, the average size of 7(a) poultry loans originated in a fiscal year increased 91 percent, from $741 thousand in FY 2012 to $1.4 million in FY 2016 (see Figure 6).

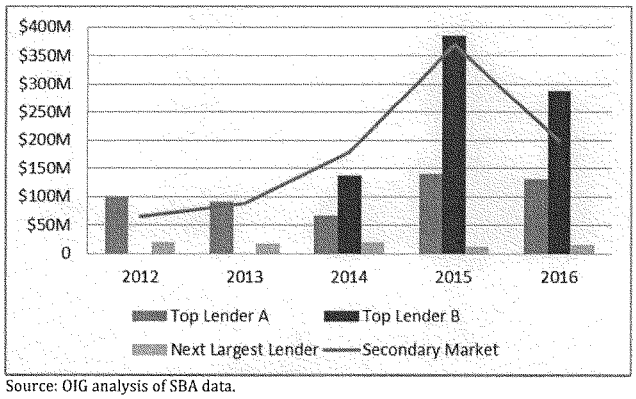
Figure 6: Growth in Annual Average 7(a) Poultry Loan Size, FY 2012–2016



Source: OIG analysis of SBA data.

Finally, as seen in the following figure, during this period, two lenders accounted for a clear majority of the approved 7(a) poultry loan value, with the next largest lender in any year accounting for a significantly smaller amount. Additionally, the value of 7(a) poultry loans approved in a given fiscal year, and then reported as sold on the secondary market, increased as much as 469 percent from $65 million in FY 2012 to $369 million in FY 2015. Although these numbers decreased in FY 2016 to $199 million, the overall increase in loans sold on the secondary market over this period was significant (see Figure 7).

Figure 7: Top Three 7(a) Poultry Lenders by Annual Value, Overlaid With the Annual Value of 7(a) Poultry Loans Reported as Sold on the Secondary Market, FY 2012–2016



Source: OIG analysis of SBA data.

Objective

This evaluation was initiated independently in response to an indication from congressional staff that large businesses were, in effect, subsidized by SBA's lending program. The concern expressed was with regard to the contracts between the growers and integrators and whether they are so controlling that affiliation exists.

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility. See Appendix I for information on our scope and methodology.

Finding: SBA 7(a) Loans Made to Growers Did Not Meet SBA Eligibility Requirements

We found that 7(a) loans made to growers did not meet regulatory and SBA requirements for eligibility. Integrators were ineligible to participate in the SBA 7(a) Loan Program due to their size; however, integrators exercised such comprehensive control over the growers that the SBA OIG believes the concerns were affiliated. Therefore, SBA and lenders approved 7(a) loans to growers that appear ineligible under SBA size standard regulations and requirements.

SBA did not recognize this affiliative control because it relied on a 1993 Agency decision based on a review of a grower–integrator contract. The review found that the contract, standing alone, did not bring about affiliation. In addition, SBA deferred to delegated lenders to effectively underwrite 7(a) poultry lending. We believe the level of control integrators had over the growers was sufficient evidence to find that from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible. As a result, SBA was guarantying loans to affiliative enterprises inconsistent with its stated mission to assist small business concerns.

Integrators and Growers Were Affiliated

It is our opinion that the relationship between the growers and the integrators was affiliative. SBA regulations in effect at the time of loan approval stated that "entities are affiliates of each other when one controls or has the power to control the other. It does not matter whether control is exercised, so long as the power to control exists. SBA considers factors such as management and contractual relationships, in determining whether affiliation exists." Further, current SBA regulations find that affiliation "arises where a single individual, concern, or entity controls the management of the applicant concern through a management agreement." Regulations and SBA standard operating procedures (SOPs) also stated that the applicant must be small under SBA size requirements and the applicant business combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is greater.

During our review of a sample of 11 7(a) loans made to growers, as well as a review of defaulted 7(a) loans, we found that integrators exercised comprehensive control over the growers through a series of contractual mandates and restrictions, management agreements, operating procedures, oversight, inspections, and market controls that overcame practically all of the grower's ability to operate their businesses independent of integrator mandates. Our observation of such control was further supported by research, studies, and reports from governmental, academic, and trade publications, as well as interviews with various lenders, growers, and staff of Federal agencies and academic institutions.

Integrator control included instructions to growers on how to inspect flocks and broiler houses, prescribing where and how to walk through the houses, the frequency and timing of inspections, and how to record the results. Integrators directed and closely oversaw grower operations in other attributes as well, including broiler house lighting, heating, ventilation, and cooling, flock feeding, watering, and the culling of birds. In addition, integrators also exercised significant control over grower facilities, providing detailed construction specifications for the grower's broiler houses, site grading, equipment, signage, and other attributes, and exercised oversight throughout the construction to ensure compliance. Following the construction of the grower's facility, integrators exercised regular and detailed oversight through inspections of broiler houses, equipment, and

facility grounds. The results of the inspections were recorded in reports that detailed deficiencies, and required the grower's remediation by a specific date and time.

Moreover, we observed that integrators made unilateral and mandatory changes to the management agreements and other operating practices that governed the grower's operations. Grower facilities were subjected to similar requirements, with integrators mandating significant capital upgrades to broiler houses and equipment. These integrator-driven changes to operating practices, and requirements for additional capital upgrades, resulted in the need for the growers to seek additional funding through the SBA 7(a) Loan Program.

Economic Viability and Value of a Grower's Facility Depended Upon a Performing Production Contract With an Integrator

We found that a grower's production contract with an integrator was the true basis for grower income and facility value. Moreover, these contracts must be performing; that is, the grower must have a steady and predictable supply of flocks from the integrator in order to remain economically viable. Our review demonstrated that a grower's failure to comply with integrator requirements, as described above could—and did—result in a significant decrease in integrator payments, a reduction of flock placements, a withholding of flocks, or the cancellation of the contract. The delays in flock placements, and their effect on the grower's cash flow, resulted in the need for the growers to seek modifications to existing loans. Further, we found that integrator refusals of further flocks, or contract terminations, resulted in the failure of grower businesses.

In addition, SBA, USDA, lenders, and appraisers recognize that broiler houses and their associated equipment are special-purpose buildings, which have little value without a production contract with an integrator. According to an executive at one lender, "without an integrator contract, the houses themselves are worthless."

To better understand the value of a production contract, we performed a review of several poultry loans that recently defaulted following the loss of an integrator contract. The review clearly demonstrated the substantial loss in the value of a grower's facility without the integrator contract (see Table 1).

Table 1: Percentage Loss in Grower Facility Value Without an Integrator Contract

Original 7(a) Loan Size	Appraised Market Value at Origination (Production Contract Assumed)	Sale Price in Final Liquidation (Without Production Contract)	Percentage Loss in Appraised Value v. Sale Price
$2,100,000	$1,950,000	$135,000	-94%
$1,975,000	$1,888,000	$720,000	-62%
$834,000	$900,000	$275,000	-69%
$594,800	$835,000	$90,000	-89%

Source: OIG Analysis of SBA Data and Loan Files.

As observed in our review, a reduction of flock placements, the withholding of flocks, or the outright cancellation of the contract directly affected the viability of the grower's business. Therefore, the integrator requirements appeared to have overcome the ability of the growers to operate as independent businesses.

Multiple Factors Prevented SBA From Recognizing Affiliative Control

SBA Relied on a 1993 Poultry Contract Review for Its Assumption of Eligibility

Although SBA loan specialists and other staff had expressed concerns that the grower–integrator relationship may be affiliative, and SBA officials and staff had stated that the growers were highly controlled by the integrators, SBA continued to rely on a 1993 Agency decision to allow for these loans.

The 1993 decision stated that in order to regard the grower–integrator relationship as affiliative, the grower's very existence as a viable business must depend upon it, as such a level of control would rob the grower of its independence.[4] SBA's decision found that the contract terms, standing alone, did not affect the viability of the grower. SBA's decision, however, did not consider the full universe of controls in place over the grower. SBA officials stated that aside from this decision, there have been no further determinations on affiliation. Moreover, SBA officials stated that a June 2016 regulatory change, which amended several tests for affiliation, made this decision immaterial.[5]

SBA Loan Specialists Did Not Have a Sufficient Knowledge Base of the Poultry Industry

SBA officials also noted that poultry loans are a very small part of the 7(a) portfolio, and as such, the Agency did not have a familiarity with poultry industry. SBA loan specialists affirmed this unfamiliarity, stating that they were not structured or resourced to develop a knowledge base on the poultry industry. Further, SBA relied on the knowledge of lenders to properly underwrite the loans for delegated lending decisions.

Conclusion

A key component of SBA's mission is to maintain and strengthen the Nation's economy by enabling the establishment and vitality of small businesses. One of SBA's goals is to grow businesses and create jobs by expanding access to capital and fuel high-growth small businesses and startups to drive innovation. As previously noted, the 7(a) Loan Program is SBA's primary program for helping startup and existing small businesses. Growers used this program to finance their facilities and meet contractual obligations of large businesses, that is, the integrators.

We found that integrators exercised significant control over the growers' operations, broiler houses, equipment, and grounds. In addition, we found that the growers' economic viability and facility value depended on a performing contract with the integrator. As such, affiliation was evident. We believe this level of control was sufficient evidence to find that from FY 2012 to FY 2016 SBA guaranteed approximately $1.8 billion in loans that may be ineligible under contemporaneous and current regulations.

[4] It is important to note that SBA was not able to locate the grower–integrator contract that was the basis of this decision, and as such, the actual terms of the contract are no longer known.
[5] 13 CFR 121.301(f)(4).

Recommendations

We recommend that the Associate Administrator for the Office of Capital Access:

1. Review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s).

2. Review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

Analysis of Agency Response

SBA management agreed with both recommendations. They plan to implement the corrective actions by August 31, 2018.

In its final response, SBA noted the report inaccurately stated loans made by the delegated lenders undergo a limited review by SBA prior to disbursement. SBA further suggested we change the statement for accuracy. However, the information stated in the report is an accurate depiction from SBA's SOP 50 10 5, which states that such loans receive a brief eligibility review. In subsequent correspondence, SBA clarified that the reviews cited in their policy are automated via SBA's electronic intake system, which includes automated rules and controls, with lender self-certification.

The Agency's response is included in its entirety in Appendix II.

Summary of Actions Necessary to Close the Recommendations

This section provides the status of recommendations and the actions necessary to close them.

1. **Resolved.** SBA management concurred with our recommendation and will perform a review of the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made proper size determinations under applicable policies and requirements. SBA will document their findings and follow up with OIG upon completion of their review. This recommendation can be closed when SBA management provides evidence that they completed the review, which includes review findings, and any appropriate actions taken.

2. **Resolved.** SBA management concurred with our recommendation and will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, SBA will establish and implement controls or supplemental guidance to ensure that SBA loan specialists and lenders make appropriate affiliation determinations. This recommendation can be closed when SBA management provides evidence that the review was completed, including their findings and any applicable controls or guidance established as a result of the review.

Appendix I: Objective, Scope, and Methodology

Our evaluation objective was to determine whether 7(a) loans made to poultry farmers (growers) met the statutory, regulatory, and SBA requirements for eligibility.

To accomplish our objective we reviewed Federal laws and regulations, SBA policies and procedures governing the 7(a) Loan Program, files of performing and defaulted loans, as well as grower–integrator contracts, agreements, and communications. We further reviewed USDA's loan program guidance, industry-related economic and analytic publications, relevant publications from state university agricultural extensions, and publications from industry trade associations. We also reviewed SBA internal communications, guidance, and selected SBA Office of Credit Risk Management lender reviews.

We interviewed officials and staff from the SBA Office of Capital Access, SBA Office of General Counsel, USDA Economic Research Service, USDA National Agricultural Statistics Service, USDA Farm Service Agency, USDA Office of Rural Development, and the USDA Office of Inspector General. We also interviewed executives and loan officers at various lending institutions, certified assessors, integrators, and growers.

We analyzed the population of 7(a) loans made to agricultural enterprises, and to the agricultural subset of poultry farmers, to obtain an understanding of the SBA loan portfolio, and its characteristics, for FYs 2012 through 2016. This population was limited to approved regular 7(a), Certified Lender Program, and Preferred Lender Program loans. Further, for this analysis, we defined agricultural enterprises to include North American Industry Classification System (NAICS) codes 111110 through 114210. The subset of poultry farmers was defined with NAICS codes 112320 and 112390. From this population, we judgmentally selected a sample of 11 loans; this sample was populated by loans at either the median size or the largest size for its fiscal year. We used this sample to guide a review of loan files, grower contracts, and grower–integrator communications, and interview parties to these loans. Further, we reviewed a sample of defaulted poultry loans to understand the degree to which integrator contracts affect facility value.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections; present all factual data accurately, fairly, and objectively; and present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objective.

Use of Computer-Processed Data

We relied on information from SBA's Mainframe Loan Accounting System to obtain multiple data sets on SBA 7(a) loans. Previous OIG engagements have verified that the information maintained in this system was reasonably reliable. Further, data elements associated to the reviewed 7(a) loans were verified against source documents. As a result, we believe the information was reliable for the purposes of this evaluation.

Appendix II: Agency Comments

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

MEMORANDUM
February 16, 2018

To: Hannibal "Mike" Ware
Acting Inspector General

From: William M. Manger
Associate Adminstrator, Office of Capital Access

Subject: Response to Draft Report on the Evaluation of SBA 7(a) Loans Made to Poultry Farmers, Project No. 17005

Thank you for the opportunity to review the draft audit report on the U.S. Small Business Administration (SBA) 7(a) Loans Made to Poultry Farmers. We appreciate the role that the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed.

SBA's Office of Capital Access (OCA) takes great effort to ensure compliance with statutory, regulatory, and SBA requirements regarding the eligibility of small business loans.
SBA issued Standard Operating Procedure (SOP) 50 10 5(J) on January 1, 2018. This version of the SOP enhances and strengthens the guidance on underwriting loans to farm enterprises, including:

1. Clarifying the prohibition on the use of SBA-guaranteed loan proceeds to obtain excess land that is not used in the operation of the applicant business; and
2. Reducing the maximum maturities of loans to farm enterprises.

OCA notes that the section of the OIG draft report titled "SBA's 7(a) Loan Program" indicates that 7(a) loans made by delegated Lenders "undergo a limited review by SBA prior to loan disbursement," which is not accurate. SBA does not perform any level of review of loans approved by delegated Lenders using their delegated authority prior to loan disbursement, as per SBA regulations,13 CFR § 120.452. That regulation requires that delegated 7(a) Lenders are responsible to independently make all loan decisions, including determining eligibility and creditworthiness; performing loan closings; and complying with all requirements of law and SBA rules and regulations. OCA recommends that OIG change that statement for accuracy.

Management's response to the recommendations in the draft report is noted as follows:

1. Review the loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination given the apparent affiliation based upon comprehensive contractual, oversight, and market control, and take the appropriate corrective action(s).

OCA concurs with this recommendation and will perform a review of the 11 loans cited in the evaluation sample to determine whether SBA loan specialists and lenders made a proper size determination under applicable policies and requirements with regard to the 11 loans reviewed. We will document our findings, and follow-up with you upon completion of our review.

2. Review the arrangements between integrators and growers under the revised regulations, and establish and implement controls, such as supplemental guidance, to ensure SBA loan specialists and lenders make appropriate affiliation determinations.

OCA concurs with this recommendation. We will review the arrangements between integrators and growers in light of the current affiliation rules and regulations. If needed, we will establish and implement controls or supplemental guidance to ensure that SBA loan specialists and Lenders make appropriate affiliation determinations.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.

Questions for the Record
Committee on Small Business
Hearing: An Examination of the Small Business Administration's
7(a) Loans to Poultry Farmers
April 18, 2018

Chairman Chabot:

1. In SBA's March 12, 2018 press release about the OIG report, SBA stated that it reviewed the loans in OIG's sample and "confirmed that they were made correctly in accordance with Agency policy at the time." This statement implies that either SBA policy "at the time" allowed affiliation or that SBA disagrees with OIG's finding of affiliation making the loans ineligible. Mr. Ware, do you agree with SBA's definition of "affiliation"? If the 2016 amended definition was in place during FY2012-2016, would your analysis of the poultry loans have been different or would you still determine them to be ineligible?

OIG Response: OIG disagrees with SBA's application of the affiliation rule and believes the loans reviewed were ineligible due to affiliation under both the current and former regulations. As outlined in the report, our belief is that these loans were ineligible according to the rules, regulation, and SBA counsel opinion in effect at the time. Our finding of affiliation is supportable under both the former and the current regulations. While the final determination of eligibility is SBA's, SBA has not provided OIG with details of their analysis to support their conclusion.

SBA's determination that the loans were made in accordance with policy "at the time" appears to be a continued reliance upon its April 28, 1993 Office of General Counsel (OGC) opinion. As stated in the report, this opinion was based on a review of a single contract between a grower and an integrator. We have concerns with this reliance. Specifically, the SBA OGC opinion explicitly limits its analysis to a reading of the base contract, referred to as a "Broiler Growing Agreement." In explaining this limitation, the OGC's opinion explicitly states that there may be other connections between the parties, such as financing or management agreements, which could bring about affiliation. However, we noted these agreements and other documents that could potentially show affiliation were not reviewed and included in the 1993 OGC opinion. Importantly, SBA OGC was unable to find the contract that underlies this opinion.

Our analysis is more extensive than a single review of a contract. For example, we reviewed a wide range of supporting documents, including, but not limited to management agreements, integrator requirements and inspections, communications between growers and integrators, and loan files. We also conducted extensive interviews with lenders, growers, integrators, industry experts, and SBA officials and loan officers. As noted in the report, our findings indicated a substantive level of integrator control. These controls included instructions to growers on how to inspect flocks and broiler houses, prescribing where and how to walk through the houses, the frequency and timing of inspections, and how to record the results. Integrators directed and closely oversaw grower operations in other attributes as well, including broiler house lighting, heating, ventilation, and cooling, flock feeding, signage, and mandatory repairs and capital upgrades.

OGC's opinion states that in order for the grower to be regarded as affiliated with the integrator, the grower's "very existence as a viable business must depend on it." In our review of the loan files, we noted that the grower's business plan, appraisal, or both showed that the business model was based upon servicing a single integrator, and running their operation to the standards of that integrator. Further, our review of defaulted loans demonstrated that the viability of the business depended upon a performing contract. This fact is illustrated not only in our report – where we demonstrate the loss of value without a performing contract – but this is also explicitly noted by lenders, growers, appraisers, USDA officials, and other industry experts.

Ranking Member Velázquez:

1. You noted that the length of the poultry contracts were typically very short. 42 percent were from "flock to flock" and another 11 were for less than a year. With the term of SBA loans to poultry growers reaching 20 years, are you concerned about creditworthiness and repayment ability for borrowers over the life of these loans?

OIG Response: OIG's opinion is that the loans in our sample were ineligible due to affiliation; however, we also recognize the significant risks to creditworthiness and repayment ability that exist in these loans. A contract poultry grower's creditworthiness and repayment ability is dependent upon a 'performing contract,' wherein the grower holds a contract, and the integrator regularly delivers sufficiently sized flocks (flock placements). For example, a grower can hold a 15-year contract with an integrator, but some of these contracts do not include a guaranty for minimum flock placements.

This 'flock placement risk' has been explicitly noted by USDA, and USDA officials have noted this risk can present a significant exposure to USDA's guaranteed loan program. Further, SBA OIG found that the appraisals required to support the creditworthiness and repayment ability of these loans also explicitly noted this risk. Often, these appraisals based their valuations on the 'extraordinary assumption' that these contracts would be performing. Moreover, the cash-flow analysis included in these appraisals relied upon a baseline of sufficiently sized, regular flock placements. OIG believes that loans approved based on contracts that do not include a guaranty for minimum flock placements pose a significant risk to a borrower's creditworthiness and repayment ability.

2. Both SBA and USDA provide loan guarantees to operate poultry growing farms. However, around 2014, growth of the SBA poultry portfolio jumped significantly, from approximately $200 million per year to $600 million in 2015. Are there specific reasons you discovered during the course of your report that these loans are not being done though the USDA?

OIG Response: Our review noted this significant portfolio growth, and we performed limited work to understand the drivers of this growth.

A detailed inquiry to the underlying causes was outside the scope of our review; however, during discussions with personnel at SBA, USDA, and various lending institutions, we noted several possible reasons for this increase. The most often cited reason was the difference between SBA's maximum loan amount ($5 million) and the USDA Farm Service Agency's maximum loan amount ($1.399 million).

3. Given that the sample size of loans reviewed was limited to 11 loans, do you believe that there is a portion or could be a portion of 7(a) poultry loans where contracts do not exert the excessive control the IG report describes between integrator and grower?

OIG Response: Our sampling methodology precludes us from making any statistical projections to the population of 7(a) poultry loans.

We analyzed the population of 7(a) loans made to agricultural enterprises, and to the agricultural subset of poultry farmers, to obtain an understanding of the SBA loan portfolio and its characteristics for FYs 2012 through 2016. This population was limited to approved regular 7(a), Certified Lender Program, and Preferred Lender Program loans. Further, for this analysis, we defined agricultural enterprises to include North American Industry Classification System (NAICS) codes 111110 through 114210. The subset of poultry farmers was defined with NAICS codes 112320 and 112390. From this population, we judgmentally selected a sample of 11 loans. This sample was populated by loans at either the median size or the largest size for its fiscal year. We used this sample to guide a review of loan files, grower contracts, and grower–integrator communications, and interview parties to these loans. Further, we reviewed a sample of defaulted poultry loans to understand the degree to which integrator contracts effected facility value.

Although our review was limited to 11 performing and 4 defaulted loans, we observed patterns and practices that made the loans ineligible for SBA assistance. These patterns and practices were observed across every reviewed loan.

4. The IG report concluded that the sample loans did not meet regulatory requirements for eligibility. However, SBA in their testimony stated these loans were made properly according to the rules, regulations, and SBA counsel opinion in effect at the time. How do you reconcile these differing conclusions, and can you explain in more depth why you determined that these loans were done in violation of SBA's rules and regulations?

OIG Response: As outlined in the report, our opinion is that these loans were ineligible due to affiliation, and as such, they were not made properly according to the rules, regulation, and SBA OGC's opinion in effect at the time. OIG believes that considering all the factors we reviewed, SBA should have made a determination that affiliation existed. While the final determination of eligibility is SBA's, SBA has not provided OIG with details of their analysis to support their conclusion.

In finding the relationship to be non-affiliative, we believe SBA exercised an over-reliance on an April 28, 1993 opinion from SBA's OGC. This opinion was based on a review of a single contract between a grower and an integrator. SBA continues to rely on this opinion. We have concerns with this reliance. Specifically, the SBA OGC opinion explicitly limits its analysis to a reading of the base contract, referred to as a "Broiler Growing Agreement" (agreement). In explaining this limitation, the OGC's opinion explicitly states that there may be other connections between the parties, such as financing or management agreements, which could bring about affiliation. None of the agreements and other documents that could potentially show affiliation were reviewed and included in the 1993 OGC opinion. Importantly, SBA OGC was unable to find the contract that underlies this opinion.

The OIG analysis included a review of numerous documents, to include, but not limited to management agreements, integrator requirements and inspections, communications between growers and integrators, and loan files. We also conducted extensive interviews with lenders, growers, integrators, and industry experts. As noted in the report, our findings indicated a tight level of integrator control. These controls included instructions to growers on how to inspect flocks and broiler houses, prescribing where and how to walk through the houses, the frequency and timing of inspections, and how to record the results. Integrators directed and closely oversaw grower operations in other attributes as well, including broiler house lighting, heating, ventilation, and cooling, flock feeding, signage, and mandatory repairs and capital upgrades.

OGC's opinion states that in order for the grower to be regarded as affiliated with the integrator, the grower's "very existence as a viable business must depend on it." In our review of the loan files it was noted that the grower's business plan, appraisal, or both noted that the business model was based upon servicing a single integrator, and running their operation to the standards of the integrator. Further, our review of defaulted loans demonstrated that the viability of the business did depend upon a performing contract. This fact is illustrated not only in our report – where we demonstrate the loss of value without a performing contract – but this is also explicitly noted by lenders, growers, appraisers, USDA officials, and other industry experts.

Congressman Comer

1. These farmers often are creditworthy but don't have access to capital elsewhere, and beginning farmers often don't have the credit history necessary to secure financing for a significant investment like a poultry grow-out house. Because of this, the 7(a) program is filling a lending gap the private sector won't otherwise fill. But based on your report's recommendations, why is OIG suggesting denying small, independent family farms access to a tool that's been proven necessary to run their businesses?

OIG Response: OIG supports the issuance of loans to small businesses that meet regulatory requirements. OIG has not suggested denying small, independent family farms access to a tool that's been proven necessary to run their business. In accordance with the Small Business Act, SBA should aid and assist independent small business concerns engaged in farming, livestock, and other agricultural endeavors, when eligible. OIG performed an evaluation of poultry loans using criteria that establishes eligibility for a loan guaranteed by SBA. We found that the loans included in our review did not meet regulatory and SBA requirements for eligibility. Specifically, the large chicken companies (integrators) in our sample exercised such comprehensive control over the growers that OIG believes the concerns appear affiliative under SBA regulations.

2. Knowing that the average age of the American farmer is 58, and that agriculture has such high barriers of entry compared to other lines of work, shouldn't SBA be encouraging young Americans to get into farming and helping families stay on their land and grow their businesses?

OIG Response: In accordance with the Small Business Act, SBA should aid and assist independent small business concerns engaged in farming, livestock, and other agricultural endeavors, when eligible.

Questions for the Record
House Committee on Small Business
Hearing: An Examination of the SBA's 7(a) Loans to Poultry Farmers
William Manger – Associate Administrator, Office of Capital Access

Chairman Chabot

1. Before the OIG started its review, did you have any concerns about the increase in the number of 7(a) poultry loans? If SBA did have concerns about the growth of the program, why did SBA not address them at the time?

Answer: Since becoming Associate Administrator of the Office of Capital Access in March of 2017, I have worked to ensure that SBA engages in strong oversight of participating lenders and that the SBA loan portfolio maintains a zero taxpayer subsidy. As part of this oversight, my staff and I review all aspects of the overall SBA portfolio, including industry concentrations and other pertinent data. Based on our review, we adopted the following three changes in January 2018 to better manage SBA's risk and exposure on small business 7(a) loans:

- Maturities on loans to farm enterprises were limited to 20 years for real estate and 15 years for machinery and equipment;
- Loans for purchase of real estate is limited to only the portion used for the applicant business; and,
- A minimum equity injection of at least 10% is required for loans to start-ups or for change of ownership.

We will assess the impact of these changes as we continue to monitor the program.

2. Can you provide a timeline for SBA's reaction to OIG finding evidence of affiliation that would make these poultry loans ineligible according to SBA size standards? When were you made aware of OIG's findings? What is the timeline for the additional actions SBA intends to take in response to OIG's recommendations?

Answer: The OIG evaluation of SBA 7(a) loans made to poultry farmers began in late 2017. SBA received a draft Evaluation Report in January 2018 and a final Evaluation Report on March 6, 2018. SBA immediately reviewed the 11 loans referenced in the OIG report and confirmed that those loans were made in accordance with Agency policy at the time. SBA released a public statement on March 9, 2018 stating that SBA would honor its guarantees of poultry loans made in accordance with Agency policy.

As agreed between SBA and OIG, SBA intends to complete its review of arrangements between integrators and growers by August 31, 2018, including conducting research and stakeholder outreach as discussed in the April 18, 2018 hearing in the House Committee on Small Business. SBA will also seek input from Members of Congress and their staff as part of the stakeholder outreach.

3. How will the Memorandum of Understanding between USDA and SBA, signed in April 2018, affect agricultural 7(a) loans going forward?

Answer: SBA is collaborating with USDA to coordinate joint efforts to assist rural entrepreneurs. The MOU is intended to bring our complementary strengths together to facilitate economic opportunities in lending and contracting, as well as to increase our outreach to various communities. As part of the follow-up to the MOU, SBA is engaging USDA and learning how SBA loan programs can best serve the agricultural community with a particular focus on rural communities. SBA is continuing to look at many factors in our analysis, including what other Agencies and Departments are doing with agricultural loans.

4. Can you tell us how the OIG's evaluation and report has affected the universe of poultry loans? How many loans have been approved during FY2018 compared to previous FYs?

Answer: There has been a decrease in 7(a) poultry loans after the release of the OIG report made in FY18 compared to same period in FY17.

Approvals / Fiscal Year	#	Amount
March - May 2017	95	$104,297,900
March - May 2018	68	$64,685,700

Ranking Member Velázquez:

1. Aside from SBA's press release titled "SBA Comments on Loans to Poultry Farmers" put on the SBA website on March 12, 2018, has SBA communicated directly with or provided any guidance to lenders on poultry loans since the IG report was released in light of SBA's statement that it will be reviewing guidance on poultry lending? If not, why not, and who made that decision?

Answer: SBA has consistently presented the same information to all stakeholders, including lenders, since the release of the OIG report: SBA will honor its guarantee on all poultry loans made in accordance with Agency policy. SBA has also informed lenders at multiple events and forums that changes to policy, if any, will not be retroactive. SBA is in the process of conducting a review regarding the arrangements between integrators and growers, which will be completed by August 31, 2018.

2. If a SBA 7(a) loan is substantially used to make leasehold improvements, SOP 50 10 5 (J) states that lenders should obtain an assignment of the lease with terms that allow for renewal that

equals or exceeds the term of the loan. Should there be similar requirements aligning broiler contract terms with the term of the 7(a) loans in the poultry industry?

Answer: SBA is in the process of conducting a review regarding the arrangements between integrators and growers. Our review will be completed by August 31, 2018.

3. Are you concerned with the findings of the report that nearly all of the value of the poultry loans is in the contracts and not the land and equipment the farm occupies?

Answer: The OIG evaluation looked at eleven loans out 1535 loans made between FY 2012 and FY 2016. SBA is undertaking a more comprehensive review of SBA guaranteed loans made to small business farmers in the poultry industry as part of its response to the OIG report.

4. You stated the new affiliation rules do not prohibit the arrangements between growers and integrators that were the focus of the IG report. Do you know why that change was made in 2016 regulation and why the regulation detailing affiliation based on identity of interest was loosened only for loan programs?

Answer: The changes to the affiliation rules were made in 2016, during the Obama Administration. According to the proposed rule published in the Federal Register, the rule change was intended to simplify and maximize the benefits for small businesses by creating "simple, bright-line tests" of affiliation for business loan program applicants.

5. Can you let us know if you or another employee of SBA has had any communication at any point with any of the poultry integrators? If so, can you please explain what those conversations have entailed? If not, does SBA plan to approach the poultry integrators in light of its agreement to the IG's recommendation that current SBA guidance on poultry lending needs to be reviewed?

Answer: SBA is including all concerned stakeholders in its outreach and research in response to the OIG report. We will be discussing all aspects of the poultry business.

Congressman Comer

1. The Small Business Administration responded to this OIG report on March 9, stating, "The SBA has reviewed those 11 loans, and confirmed that they were correctly made in accordance with Agency policy at the time. The loan guarantees will continue to be honored for those and other similar poultry loans." Can you expand on SBA's position of standing by and continuing to issue these loans?

Answer: As noted in the March public statement, SBA will continue to honor any poultry loans made in accordance with Agency policy in effect at the time. SBA is in the process of conducting

a review regarding the arrangements between integrators and growers, which will be completed by August 31, 2018.

2. Can you describe how the program has been successful for everyone involved—grower, bank and government?

Answer: Poultry loans comprise less than 2% of the SBA 7(a) loan portfolio. Loans made to small business farmers in the poultry industry have a default rate of 0.34%, as opposed to the overall 7(a) portfolio default rate of 0.70%. SBA's guarantee enables banks and other lending institutions to support their communities by increasing loans made to small business farmers, who create jobs in the community and who provide an affordable source of protein to Americans and others around the world.

3. How has the 7(a) program been helpful to growers in operating and fulfilling their dreams of expanding their businesses or keeping their family farm on their land?

Answer: SBA-guaranteed loans allow small business farmers to participate in the agricultural industry and to grow their businesses. Providing this access to capital allows long-standing family farms to continue and prosper.

April 26, 2018

House Small Business Committee

Statement for the Record

Hearing: "An Examination of the Small Business Administration's 7(a) Loans to Poultry Farmers"

Wednesday, April 18, 2018

Statement for the record by Hon. James Comer, Kentucky

Barriers to entry in agriculture are very high, especially for small businesses. While large companies can use capital markets to raise financing, small businesses typically use traditional banking and often have trouble obtaining financing through the traditional lending market. Many do not have the credit history or large collateral necessary to obtain private financing and overcome these barriers. Small businesses are then either unable expand their farm, must obtain their financing through the Small Business Administration's public-private partnerships with private lenders, or are shut out from agriculture entirely.

The 7(a) loan program fills a lending gap in the market for poultry growers by offering guarantees of repayments made to the lenders. By doing so, banks are provided the ability to extend credit to otherwise unproven entrepreneurs, farmers are provided a cash flow and access to capital they otherwise couldn't find, and the government makes its money back on an investment in American agriculture at no cost to the American taxpayer. The 7(a) program minimizes uncertainty to small, independent family farms and incentivizes young Americans who want to start their own business in agriculture.

Particularly when the farm economy is experiencing a downturn, as it is now, we should be doing all we can to provide certainty and stability to America's farmers, and administering necessary loan guarantees to poultry growers to maintain this stability.

CAMPAIGN FOR CONTRACT AGRICULTURE REFORM

a voice for contract farmers, ranchers, and their communities

Testimony of Steven D. Etka
Policy Director, Campaign for Contract Agriculture Reform
submitted to the
Small Business Committee
U.S. House of Representatives
regarding
"An Examination of the Small Business Administration's 7(a) Loans to Poultry Farmers"

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

Thank you for this opportunity to submit testimony on behalf of the Campaign for Contract Agriculture Reform (CCAR) with regard the use of the Small Business Administration (SBA) 7(a) Loan Guarantee program for poultry production loans.

CCAR is a national alliance of organizations working to provide a voice for farmers and ranchers involved in contract agriculture, as well as the communities in which they live. The goal of the campaign is to assure that the processor-producer relationship serves as a fair partnership, rather than a dictatorship.

Production contracts in the poultry sector are notoriously unstable for individual poultry growers. Even though growers are required to make very large investments to build specialized, sole-purpose chicken houses on their own property in order to service a poultry production contract, they have few if any protections against premature contract cancellation, suspension of flock delivery, and/or unexpected and unaffordable capital upgrade requirements. Growers must often tap into their own savings to avoid defaulting on the loans, as many of the contracts do not cash flow.

In a normally functioning capital market, capital for these poultry operations would dry up because the contracts are so economically risky to the grower and the lender. The lack of capital would force poultry integrators to modify their contracts to be more balanced and stable for the grower, and less risky for the lender. However, because of the federal loan guarantees, the normal scrutiny by lenders of the contracts that underlie these loans is not taking place and the unsustainable poultry production model persists. In this way, we argue that both the SBA 7(a) program and the FSA loan guarantee programs are underwriting and subsidizing the very abusive contracting practices of the U.S. poultry sector, contributing to the economic distress that is common for poultry growers and the poultry-dependent communities of our nation.

Therefore, we are very pleased that SBA Inspector General and the House Small Business Committee are scrutinizing the appropriateness of using the SBA 7(a) loan guarantee program for contract poultry production. We believe that data included in the SBA Inspector General (IG) report clearly show that the overwhelming majority of the value of a contract poultry operation is based on the contract itself, and that if the grower loses their contract with the poultry integrator, the value of the property used to collateralize the loan is drastically reduced. It is precisely this

control over the poultry grower's livelihood, and the unsustainable and one-sided nature of the contract, that makes poultry growers so economically vulnerable.

In addition, it is also important to note that standard production budgets developed by integrators for poultry operations are not an accurate reflection of the actual financial conditions faced by poultry growers. Many poultry growers are initially attracted to the poultry contract production business based on these often-misleading budgets developed by integrators seeking new growers. But once the growers have taken out the loans and built their chicken houses, they often find that their income can vary greatly, depending on conditions out of their direct control. These conditions include increased energy cost, increased idle time between flocks, variations in the quality of the integrator-supplied feed and chicks, reduced bird density, forced equipment upgrades, etc.

Because of the extreme control that poultry integrators have over contract poultry growers it is entirely appropriate that the SBA IG report is sounding the alarm about the close affiliation between large poultry integrators and the poultry growers with whom they contract.

We agree with the Chairman and Ranking Member that the IG should also be asking questions about the "credit elsewhere" test with regard to SBA poultry loans. In our experience, it is very difficult for poultry growers to receive financing for their operations without the backing of an SBA or USDA Farm Service Agency (FSA) loan guarantee. The reason for this is that the contracts are very unstable for the grower, and often do not cash flow. The grower goes deeply into debt to build very specialized poultry grow-out houses on their property as a prerequisite for securing a poultry production contact with an integrator. The contract usually includes language that will allow the integrator to end or reduce bird placements in the grower's poultry houses based on future market conditions outside the grower's control. The typical poultry production contract also includes a very opaque payment system that results in a wide variation in compensation for the grower's services and facilities based on factors (such as chick and feed quality) that are completely outside the grower's control and unrelated to their performance.

We also recommend that the Committee and the Office of Inspector General delve into the use of SBA 7(a) loans in the hog production operations as well, since those contract relationships are starting to mirror those in poultry.

In closing, we would like to associate ourselves with the recommendations made by Scott Marlow of the Rural Advancement Foundation International- USA (RAFI-USA) in his submitted with regard to use of the SBA 7(a) loan guarantee program for poultry loans. Specifically, we recommend that:

1. Existing loans for contract poultry operations be continued, and borrowers serviced with clear standard operating procedures regardless of the lender's status as standard, certified or preferred lender.

2. In addition to their findings that SBA 7(a) loans for poultry operations did not meet SBA eligibility requirements, SBA review the loans for feasibility based on the extreme dependence of both the income required to repay the loan and the value of the collateral on the singular contract, the ease with which the contract could be altered or cancelled to eliminate both repayment ability and collateral, and the lack of alternative contract opportunities available to service the loan.

3. The Small Business Administration increase their oversight of loans based on any production contract, including but not limited to broilers, turkeys, hogs, eggs and other livestock to require that any contract assure sufficient income, in both placement of animals and net return, sufficient to repay the loan for the duration of the loan, without clauses that allow suspension, delay or reduction of placements due to factors outside the producers control.

4. The Office of the Inspector General review existing loans for other production contracts, including hogs and turkeys for both eligibility and feasibility, and provide clear direction that SBA 7(a) loans not be used for production contracts with reported levels of affiliation and dependence on a single company for both repayment ability and the value of collateral.

Thank you for your consideration of these comments and your work on this issue.

Testimony of W. Scott Marlow
Senior Policy Specialist, The Rural Advancement Foundation International - USA
submitted to the
Small Business Committee
U.S. House of Representatives
for the
April 25, 2018 hearing entitled,
"An Examination of the Small Business Administration's 7(a) Loans to Poultry Farmers"

Chairman Chabot, Ranking Member Velazquez, and distinguished members,

The Rural Advancement Foundation International – USA (RAFI-USA) is grateful to the committee for this opportunity to submit written testimony regarding the use of Small Business Administration 7(a) loan guarantees for poultry farms.

RAFI-USA is a non-profit organization that works for justice, equity and sustainability in agriculture and rural communities. Since the 1980's, RAFI-USA staff members have provided in-depth financial counseling to approximately 100 farmer families per year who are facing financial crisis and the potential loss of their farms. Currently, approximately 20% of our cases are farmers involved in production contracts for confinement poultry operations, many with SBA 7(a) loan guarantees. Because of our long history of serving farm families in poultry and hog production contracts, we have an in-depth understanding of both the contracts and the loan packages that tie farmers to those contracts.

On its release, we reviewed the report of the Small Business Administration Office of Inspector General on the use of 7(a) loan guarantees for poultry operations with a group of current and former poultry farmers. In their experience, the findings of the report, including the comprehensive control exercised over the farmer by the integrator through the contract, the increasing scale and term of loans guaranteed, the dependence of both grower viability and the value of the facility on the contract and the lack of oversight on the either the establishment or servicing of these loans matches their experience, and they join us in expressing our gratitude to the committee and the Office of Inspector General for this report. Their comments have been included in the body of this testimony.

We concur with the report that these contract arrangements are affiliative, and violate the eligibility requirements of Small Business Administration. They are also in violation of the program's focus on valuing entrepreneurship, as laid out in the following from the FY 2018 Small Business Administration budget request: "Our nation's entrepreneurs are innovators who take a risk on an idea, invest in their

communities and create jobs. Their skills and creativity not only support their own families, but they also make our neighborhoods vibrant places to live and work and fuel our nation's economic strength."

We also believe, and will further illustrate below, that based on the high level of dependence of both financial viability and the value of collateral on the specific contract, these loans also violate the program prohibition of use of 7(a) loan proceeds to pay for a non-sound business purpose.

We urge the committee to broaden the scope of inquiry beyond poultry loans. The highly vertically integrated structure represented by poultry production contracts is not limited to the broiler contracts examined for this report. According to the 2012 US Census of Agriculture, 97% of all broilers, 43% of all hogs, 68% of all turkeys sold are produced under production contracts.[1] The concerns raised in this report will apply equally to these growing percentages across agriculture.

The findings of the report must be seen in the context of other recent research on the structure of the poultry industry, especially the reliance of the farmer's financial viability and the value of collateral on the contract itself. According to James MacDonald's USDA Economic Research Service Report "Technology, Organization and Financial Performance in U.S. Broiler Production," 51.9% of broiler producers are in geographic areas with 1 or 2 integrators, significantly limiting the opportunity for switching to another integrator in the event of a contract termination.[2]

In addition, while the life of 75% of the loans is at least 15 years, MacDonald's report shows that by year 11, as many as 70% of contracts are less than 12 months in duration. Producers are completely dependent for their financial viability, the value of their investment and for all of their property held as collateral on short-term contracts for which there is little or no alternative. We believe that this situation qualifies as a non-sound business purpose.

The use of guaranteed loans for contract poultry operations facilitates an extraordinary level of control of companies over the producer, and allows the integrator to externalize the costs and risks associated with fluctuation of production capacity without cost. The contract arrangement allows the integrator to increase production capacity by bringing new producers into production, decrease production capacity by cutting off existing producers, and force implementation of new technologies to increase the return for the company all at the expense of the producer. Existing producer's contracts can be terminated with no cost to the company, and, through the guarantee, with no risk to the lender.

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[1] 2012 Census of Agriculture, United States Department of Agriculture, National Agricultural Statistics Service.

[2] MacDonald, J.M, 2014, Technology, Organization, and Financial Performance in U.S. Broiler Production. United States Department of Agriculture Economic Research Service Economic Information Bulletin Number 126.

While production contracts are often marketed to producers as protection from market fluctuations, the combination of guaranteed loans, short-term contracts and few or no alternatives either within the industry or outside of the industry that allow the producer to service the loans allows the integrator to externalize the costs and risks of market fluctuations onto the producer, and, through the guaranteed loan, onto the taxpayer. In USDA comments, representatives of the National Chicken Council and the U.S. Poultry and Egg Association objected to proposed requirements that producers receive a 90-day warning before suspension of delivery of birds specifically because this requirement would not allow the companies to transfer fluctuations in the marketplace onto the producers fast enough.[3] [3]

While the farmer takes on the risk and cost of production capacity, as demonstrated in the report, they are far from independent business operators. The entrepreneurship that the 7 (a) Guaranteed Loan program is designed to foster is a far cry from the contract arrangement, where every aspect of the business, from the design of the building to the exact equipment to all aspects of flock management are determined by the company. Any producer who exercises any level of creativity or true entrepreneurship risks the loss of their farm, home and income. This arrangement does not live up to either the intent or the directives of the Small Business Administration 7(a) loan guarantee program.

Many poultry contracts include appropriate terms for termination of the contract for causes such as animal cruelty, improper disposal or failure to adhere to local regulations. But many also include clauses that allow the integrator to adjust the timing and number of birds in placements based on market conditions. This clause essentially renders a contract of any duration a flock-to-flock contract, and provides no assurance that the producer will receive income sufficient for repayment of the loan.

We have seen many instances where, due to unwarranted suspension of placements or reduction in the number of birds placed, producers were forced to take off-farm employment to make payments on their poultry loans or, as they say, "Get a job in town to pay for my chicken habit." If a producer's contract is terminated, even if they are able to find alternative income to make loan payments, the reduction in asset value threatens the loss of their home and land due to non-monetary default.

We would also like to draw to the Committee's attention our experience that different preferred lenders provide different levels of loan servicing to borrowers in 7(a) guaranteed loans. For some families that we have assisted, their sole communication from the bank regarding their loan delinquency and servicing options was a notice of foreclosure.

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[3] Watts, G. and J. E. Starkey, Farm Bill Comments, Federal Register, June 22, 2010, Volume 75 No. 119 page 35338, Docket RIN 0580-AB07, submitted on behalf of the National Chicken Council and the U.S. Poultry and Egg Association, November 22, 2010

We share two concerns with the opportunity for guaranteed lenders to service loans, including opportunity for refinancing, based on their internal procedures. First, this difference between lenders is a non-transparent difference in the delivery of a Federal program. Borrower's rights to notification and servicing can make a very significant difference in the outlook for the loan and for the borrower, and would differ based on which guaranteed lender originated the loan.

Second, clear directives that guaranteed lenders exhaust all possible options for finding a feasible refinancing plan for delinquent loans before immediate foreclosure increases benefits for the borrower, keeping farm families in their homes and on the land, and reduces program costs to the taxpayer by reducing the likelihood of government payment of the guarantee.

We therefore provide the following recommendations, that:

1. Existing loans for contract poultry operations be continued, and borrowers serviced with clear standard operating procedures regardless of the lender's status as standard, certified or preferred lender, or lender's internal procedures.

2. In addition to their findings that SBA 7(a) loans for poultry operations did not meet SBA eligibility requirements, SBA review the loans for feasibility based on the extreme dependence of both the income required to repay the loan and the value of the collateral on the singular contract, the ease with which the contract could be altered or cancelled to eliminate both repayment ability and collateral, and the lack of alternative contract opportunities available to service the loan.

3. The Small Business Administration increase their oversight of loans based on any production contract, including but not limited to broilers, turkeys, hogs, eggs and other livestock to require that any contract assure sufficient net income, in both placement of animals and net return, sufficient to repay the loan for the duration of the loan, without clauses that allow suspension, delay or reduction of placements due to factors outside the producers control.

4. The Office of the Inspector General review existing loans for other production contracts, including hogs and turkeys for both eligibility and feasibility, and provide clear direction that SBA 7(a) loans not be used for production contracts with reported levels of affiliation and dependence on a single company for both repayment ability and the value of collateral.

We thank the committee for their consideration.

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