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OVERSIGHT OF SBA'S IMPLEMENTATION OF FINAL RULES TO EXPAND ACCESS TO CAPITAL

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

OF THE

UNITED STATES SENATE

ONE HUNDRED EIGHTEENTH CONGRESS

FIRST SESSION

APRIL 26, 2023

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OVERSIGHT OF SBA'S IMPLEMENTATION OF FINAL RULES TO EXPAND ACCESS TO CAPITAL

WEDNESDAY, APRIL 26, 2023

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP,
Washington, DC.

The committee met, pursuant to notice, at 3:33 p.m., in Room 428A, Russell Senate Office Building, Hon. Benjamin Cardin, chairman of the committee, presiding.

Present: Senators Cardin [presiding], Shaheen, Hirono, Rosen, Hickenlooper, Ernst, Risch, Young, Hawley, and Budd.

OPENING STATEMENT OF SENATOR CARDIN

The CHAIRMAN. The Small Business committee will come to order. Let me welcome our guests today. This hearing is scheduled for the oversight of SBA's implementation of final rules to expand access to capital.

So, today's hearing will examine two new rules SBA finalized this month that aim to address the gaps in small business lending. The first would lift the moratorium on the number of small business lending companies, or SBLCs, participating in the SBA's flagship lending programs.

The second would loosen affiliation standards and streamline lending criteria requirements in SBA's small business loan programs.

These rules first proposed six months ago and scheduled to go into effect on May the 12th, make significant changes that will affect which borrowers and lenders participate in SBA's lending programs going forward.

Notably, the rule significantly reconfigured the Community Advantage Program, which has been successful in providing capital to small businesses and communities that historically have been left behind.

While I recognize that the SBA issued these rules with the goal of expanding access to capital for businesses in underserved communities and increasing the number of small dollar loans, I am concerned that the final rules do not offer the stability or specifics necessary to ensure Community Advantage's future success.

I also worry that the rules that leave so many decisions to the discretion of the agency would have unforeseen and possible regrettable consequences down the road.

Like many of us, I was disappointed that the final versions of these rules are almost identical to those that were proposed. Giving the degree of interest from so many corners and the significance of changes under consideration, it is surprising that the agency wasn't more receptive of many of the constructive comments it received.

In our hearing with Administrator Guzman last month, we received assurances that many of our concerns would be addressed, yet the rules were released without the SOP guidance, which detail how the rule will be implemented and without meaningful changes.

Lenders and borrowers need to know what will be expected of them as these rules are implemented and scheduled to go into effect on May 12th. And while the SOP guidance will address some of the missing details from the final rules, the fact that the agency retains discretion to make critical decisions on a case-by-case basis means that many program participants will remain uncertain about where they stand.

This is particularly true for Community Advantage lenders. While I appreciate that the SBA aims to give the program stability through the rulemaking, many lenders may not even be aware that the program will be transitioned into the SBLC lending program in the coming months or understand what that entails.

Even more concerning, the rule allows the SBA to make case by case decisions about important matters like lenders' required loan loss reserves and capital requirements. It worries me that this program could be changed dramatically by subsequent Administrations without any notice to the public by issuing new SOP guidance.

Furthermore, I am concerned that these rules do not ensure the long-term integrity of the Community Advantage's important mission. The final rule does not specify target markets or metrics for success, thereby eliminating the key markers and accountability measures that previously ensured the underserved markets were served.

Access to capital in underserved communities has been a persistent weakness of SBA lending programs, but Community Advantage has been our most successful program in reaching these small businesses.

The program allows mission-oriented nonprofits to make 7(a) loans up to $350,000, focusing on economic development for underbanked small business owners. Although it is smaller, more targeted program than 7(a), the Community Advantage program has been very effective in addressing the credit gap.

As I have repeated since this rulemaking process began and long before, I believe the Community Advantage needs the stability that comes with statutory codification. The Community Advantage Program was created as a pilot more than a decade ago, and now in recognition of its success, connecting underserved small businesses with capital, Congress needs to make it permanent and establish fixed, transparent requirements.

I will continue to push our community to do just that as part of our bipartisan reauthorization process. I just might point out that part of the reason we are here today talking about the rule and our concerns is that Congress has not acted in this area.

We have a responsibility as Congress to give the guidelines. That is why I think it is absolutely essential that we move forward with our bipartisan reauthorization of the SBA laws, where we can speak to the specifics. And if we don't do that, we are ceding of our authority to the Executive Branch.

This is not to take away from the many good ideas in these rules, some of which will speed up loan approvals for modernizing the underwriting process. However, the changes seem heavily focused on giving lenders greater autonomy and less guidance, enabling them to rely on automation.

Absent proper oversight, it is easy to imagine a scenario in which these changes enable predatory lending practices to creep into the program. Efforts to increase speed and volume can help modernize SBA programs, but they must be accompanied by corresponding commitments to exercise caution and vigilance.

The rule gives considerable new responsibilities to the Office of Credit Risk Management, or OCRM. However, according to a recent whitepaper released by the Inspector General, this office is currently short staffed and has been for some time.

While Administrator Guzman told us earlier this month that SBA is confident that OCRM can handle both its current and future responsibilities with its existing staff levels, the Inspector General observed that the office is not currently keeping up with the oversight of the 7(a) loan program.

Given this new direction, I remain concerned that the President's budget did not recommend an increase for OCRM, assuming the agency knew these rules were close to being finalized in the coming year, the budget request should have accounted for the growing importance of this office as a primary overseer of the agency's lending programs.

Again, while we may not see eye to eye on all the particulars, I do want to commend the Administration for its commitment to expanding the reach of SBA lending programs to underserved communities.

And I assure the Administration, I want to work together, I want this committee to work with the Administration in order to accomplish our mutual goal of extending credit opportunities, particularly to the smaller small businesses and those in underserved communities. Small businesses across the country rely on 7(a), 504, Community Advantage, micro loan programs.

Lenders and small businesses alike need these programs to remain stable, transparent, and sufficiently empowered to reach underserved borrowers. These should be our guiding principles.

I look forward to hearing from both panels of our witnesses today so we can better understand the concerns and we can move forward on a common agenda. And with that, let me recognize the distinguished Ranking Member, Senator Ernst.

Senator ERNST. Thank you, Mr. Chair, and thanks to our witnesses for being here today.

And given the importance of today's hearing, according to our committee's rules, any member of the committee shall be empowered to administer the oath to any witness testifying as to fact.

So, if you both please would rise and raise your right hand, I will administer the oath. Do you solemnly swear to tell the truth, the whole truth, so help you God?

Mr. KELLEY. I do.

Mr. SHOEMAKER. I do.

OPENING STATEMENT OF SENATOR ERNST

Senator ERNST. Okay. Thank you very much. Just one month ago, Administrator Guzman was before this committee, and Chairman Cardin and I both expressed concerns with the SBA's new proposed lending rules.

Fast forward to our very next committee hearing today, and now the rules are final, and none of the concerns we discussed were considered or addressed. It is really disheartening to many of us on this committee, as we saw in a bipartisan manner, where numbers of our committee members raised issue with the proposed rules, and it shows that the Administrator and the SBA was not working in good faith with us.

These final rules threaten to drastically change the SBA's flagship small business lending program. The Administration will allow for an unlimited amount of non-depository institutions, fintechs, to become permanently licensed SBA lenders.

It also removes underwriting standards that will inevitably increase risk. Taxpayers recently witnessed the Federal Government lose more than $64 billion in paycheck protection program funds due to fintechs facilitating widespread financial fraud and improper loans.

Yet before oversight investigations into these entities have crossed the finish line, the SBA has decided that now is the time to replace community lenders with artificial bots.

The SBA is not prepared to evaluate the use of artificial intelligence or machine learning algorithms for underwriting and loan processing, nor does it have the capacity to enforce Federal anti-money laundering laws and know your customer compliance, which are vital controls in the U.S. financial system to keep money from flowing to and between bad actors.

The rules state that it will fill the market gap for smaller dollar loans to underserved borrowers. But the rules do not limit the new non-bank lenders to small dollar lending. It begs the question, do we think fintechs will pursue small dollar loans or take up the opportunity to do $5 million loans if they have the ability to be repaid by the Government for a default?

At the same time, the rule will allow for larger businesses to exploit these programs intended for truly small businesses. Lastly, the rules will give the SBA Administrator the authority to reverse loan decisions, forcing lenders to provide a loan, which is a backdoor way to direct lending by the agency.

These sweeping changes will encourage risky lending behavior, causing subsidy rates to rise and increase fees on the very borrowers that SBA is trying to help. In spite of a bipartisan push for the SBA to exercise diligence and restraint, the SBA has ignored Congress, Democrats and Republicans, specifically this committee, every step of the process and is moving full speed ahead.

Mr. Chairman, I do hope that we can work together to reign in the SBA's ill-conceived changes to these critical programs and actually address the gaps in small dollar loans and lending in rural America.

Shifting loans from our banks on Main Street to bots in San Francisco isn't the best interest of our small businesses in Iowa, nor across the United States. And I want to be very clear about this, we need to come to a bipartisan agreement on a legislative response to these rules before we begin negotiations on other aspects of modernizing the SBA.

Small business lending is the foundation of SBA's programs, and we can't undertake renovations to the rest of the agency until this dire problem is fixed. Thank you, Chairman.

The CHAIRMAN. Let me thank the ranking member. We will now hear from our first panel of witnesses. Let me introduce both. Thank you both for being here.

Mr. Patrick Kelley serves as the Associate Administrator for the Office of Capital Access at the Small Business Administration.

In this role, he is charged for overseeing the office's operations, and the office is responsible for making capital available to small businesses through banks and other lending partners. This is his second stint at SBA, as he previously served in several positions during the Obama Administration.

And Mr. Shelton Shoemaker serves as the Deputy Inspector General for the SBA's Office of Inspector General. He has been with OIG since 2011. He served in numerous positions at that agency before assuming his current role.

As the Deputy Inspector General, he serves as a principal advisor to the Inspector General and assists in overseeing the office's operations.

Without objection, both of your full statements will be made part of the record. You may proceed for approximately five minutes, leaving time for us to be able to ask questions. We will start with Mr. Kelley.

TESTIMONY OF PATRICK KELLEY, ASSOCIATE ADMINISTRATOR, OFFICE OF CAPITAL ACCESS, U.S. SMALL BUSINESS ADMINISTRATION

Mr. KELLEY. Chairman Cardin, Ranking Member Ernst, members of the Small Business committee, thank you for the opportunity to appear here today on behalf of Administrator Guzman and the Biden-Harris Administration.

I began as the Associate Administrator for the Office of Capital Access in March of 2021, and as the Chairman mentioned, I have been responsible for the Paycheck Protection Program, the COVID EIDL loan program, the Restaurant Revitalization Program, and now oversee the 7(a) program, the 504 program, micro-loans, and the Surety Bond Program.

What I want to start first by saying today is for the first two years of this position, the number one priority from Administrator Guzman was to take care of the challenges that we inherited when President Biden took office regarding the CARES Act programs.

Over the last two years, we have screened 49 million applications across the CARES Act programs, PPP, and COVID EIDL, as well as SVOG, and Restaurant Revitalization, which were part of the American Rescue Plan.

We have flagged almost 6 million files for suspicious activity, we have conducted 3.5 million manual reviews, and we have referred over 3 million instances of attempted fraud in what we believe is fraud on disbursed loans. Close to 800,000 loans that were dispersed and 3 million more that were attempted.

So roughly $40 billion is the fraud estimate that we believe was dispersed, and $60 billion of attempted fraud totaling $101 billion. And we intend to support, and our budget reflects that from President Biden, the Office of the Inspector General in their attempt to go get the bad guys that we have identified.

Since Administrator Guzman took office, we have made every single piece of data available to the Office of the Inspector General. Our predecessors sued the Office of the Inspector General and the public to keep that information private, which I believe created and exacerbated the issues regarding the allegations and estimates of fraud.

We have addressed all of the material weaknesses that we inherited, IP static address, failure to check business address, automated screening, data analytics to determine which supervised learning models, which prioritized files we need to manually review.

So, I start there because it is important to understand that for two years, we have, through automated screenings, through data analytics tools, through manual reviews, referred now 3.5, 3.6 million applications to the Office of the Inspector General for them to go after, and we will continue to work with them on that.

I start there because it is important to understand that the CARES Act program legacy will not simply be the management challenges that the Biden-Harris Administration handled, but what the Biden-Harris Administration did to stop that, to put an end to it, and then to take from there and make sure it never happens again.

In our programs moving forward, and I look forward to discussing all of the issues that Ranking Member Ernst and Chairman Cardin addressed, I look forward to discussing how we will screen in all of our existing programs pre each ran authorization for eligibility and fraud moving forward.

And I am happy to get into the details of that. We believe that that is an important step that will be reflected in my colleagues, Deputy Inspector General Sheldon's testimony regarding the need for reviewing borrower and lender certifications so that we never again go to the point where we are relying on lender or borrower certifications.

So, the last thing that I will share with my remaining minutes that I think is important for the members of the committee to understand and is important for me to share with the rest of the folks here, my family comes from Manchester, Connecticut.

My parents grew up in East Hartford, which is the home of John Larson, and my grandmother lived on Mitchell Drive there, and it was an FHA home, post-World War II. She worked as a clerk in a grocery store. My grandfather worked in Pratt Whitney as a firefighter.

When my grandmother passed away, my mother was in the house or finishing up the estate, and at a certain point, maybe she wouldn't want me to share this, she was cursing a blue streak from the kitchen. In these houses, and for the kids here that don't remember, there were phones with cords, extension cords that would go throughout.

And my mother was cursing a blue streak because she learned that my grandmother was leasing her phone, the phone on the wall, from the phone company. That phone company had taken advantage of my grandmother and cost her money that that Social Security check was precious.

So, I remember this vividly, and I understand what our responsibility is to go after charlatans in the financial markets. And I have spent a career working on those issues, and I look forward to handling all the questions today and working with the committee as we move forward. Thank you.

[The prepared statement of Mr. Kelley follows:]

Congressional Testimony Prepared for SBA Associate Administrator Patrick Kelley
U.S. Senate Committee on Small Business and Entrepreneurship
Hearing on Oversight of SBA's Implementation of Final Rules to Expand Access to Capital
April 26, 2023

Chairman Cardin, Ranking Member Ernst, and distinguished members of the committee, thank you for the opportunity to appear before you today to discuss the SBA's Office of Capital Access.

Since March 2021, I have served as the Associate Administrator for the Office of Capital Access (OCA). Previously I served as Deputy Chief of Staff, Deputy Associate Administrator, and Senior Advisor for the SBA as well as a banker in the private sector.

In my current role, I am responsible for the Office of Capital Access's administration of SBA's 7(a) business loans, the Community Advantage Pilot program, the 504 Loan Program, the Surety Bond Program, the Microloan Program, and SBA disaster lending. Collectively, SBA's business loan programs connect creditworthy small business entrepreneurs who otherwise are unable to obtain conventional sources of capital with the necessary capital to start or grow small businesses.

Capital is the lifeblood of any business and critical to helping small businesses grow, hire, acquire, and innovate. In 2022, SBA approved more than $43 billion across our capital programs. Specifically, that includes $25.7 billion in 7(a) loans to 47,678 small businesses across the nation. Additionally, SBA approved $9.2 billion in 504 loans last year – a $1 billion increase year over year from 2021.

One of the persistent problems for small businesses has been the availability of small dollar lending. The number of SBA 7(a) loans under $150,000 approved annually has fallen from 38,000 to 22,000. In FY22, the SBA increased the number of small 7(a) loans for the first time since 2016. However, there are still large gaps in the availability of loans under $150,000.

When businesses cannot access capital, there are significant consequences and limited opportunities for underserved communities – including minority populations, women, veterans, and rural Americans.

Under Administrator Guzman's leadership, SBA is committed to addressing this market gap with improvements that streamline our programs in order to better deliver on our mission and reach underserved businesses.

For nearly two years, SBA has been engaged in rulemakings to improve access to capital.

In November 2022, SBA published proposed rules to revitalize the Small Business Lending Program and streamline the affiliation rules for SBA loans. Both of these rules were open to public comment for 60 days and SBA has diligently worked through all of the public comments we have received.

After extensive engagement with this Committee and our stakeholders on Capitol Hill, a notice of these Final Rules was published this month.

SBLC Rule

The SBA is revitalizing the Small Business Lending Company (SBLC) program by removing the 1982 cap on the number of licenses for these non-depository institutions at just 14 licenses. Removing this outdated cap will create needed competition in the marketplace and provide additional options to small business borrowers.

Today, SBA is a modern, technology-forward agency that has the capacity to undertake these reforms by leveraging the talented agency staff along with private sector contracts to ensure appropriate oversight for all lenders.

By lifting the cap on regular SBLC licenses, SBA will be able to admit additional lenders aligned with the agency's mission. SBA will begin by issuing up to three additional SBLC licenses to lenders with demonstrated historical performance of safety and soundness, and a strong regard for borrower financial health and protection. Administrator Guzman has made clear that SBA's objective is to increase the number of lenders serving the hardest-to-reach small businesses, including women, minorities, veterans, and rural firms, at no cost to the taxpayer.

Importantly, this rule incorporates Congressional intent by providing permanence to the more than one hundred nonprofit, mission-oriented lenders in the Community Advantage Pilot Program. Community Advantage has been a powerful tool to increase capital in underserved communities but a lack of certainty has limited the program from reaching its full potential. SBA will transition pilot program lenders into Community Advantage SBLC licenses to add certainty to their participation and attract additional nonprofit lenders.

Affiliation Rule

Throughout my time at SBA, we have heard feedback from stakeholders – including Congress – that SBA's programs are overly complex and that red tape hinders some borrowers from accessing our programs. Last year, 20 lenders made half of all 7(a) loans. It doesn't have to be that way. With easier access and simpler rules, more community banks, credit unions, nonprofit and other lenders can participate more; that's what's best for small businesses.

SBA's rule to modernize the lending criteria and conditions for SBA's business loan programs will expand the number of creditworthy business owners who can access SBA loans, including women, minority entrepreneurs, employees purchasing a portion of a business from its owner(s), and startup small businesses. These enhancements align with existing lender best practices to make it simpler and easier for lenders to make SBA loans.

The new lending criteria will, for SBA's 7(a) Loan Program and 504 Loan Program, allow lenders to make SBA loan decisions based on their existing practices for similarly sized non-SBA loans under $500,000, using credit score, business revenue, and any equity or collateral to approve or deny a loan application. This simplification will allow lenders to use the same process they currently use for SBA Express and for similarly sized, non-SBA commercial loans. The rule also provides additional flexibility for smaller loans (under $150,000) to reduce the cost and complexity of smaller dollar lending.

Another area of complexity has been SBA's affiliation rules which determine if a business qualifies as a small business when taking into account all affiliated entities. SBA has used a complex test to determine control of an entity, and today we are proposing simplifying the affiliation test based upon feedback from small business lenders. Streamlining affiliation standards benefits small businesses by reducing the paperwork burden and ensuring that more businesses can access SBA financing. At the same time, they increase access for lenders and simplify the process for lenders to make an SBA loan to align with existing lender best practices they already use for similarly situated commercial loans.

Criminal History Records Rule

America is a nation that believes in second chances, particularly salient for the date of this hearing during Second Chance Month. Leaders on both sides of the aisle have identified stable employment as a key predictor of success during reentry, especially in terms of reducing the risk of recidivism. Not only does this strengthen our economy, but it also makes our communities safer. Employment also includes pathways to entrepreneurship for qualified justice-impacted individuals.

Although individuals who have been arrested for non-felony convictions are currently eligible for most SBA programs, asking questions about criminal history often creates a chilling effect that deters people from applying even if they would qualify. SBA is exploring potential options that would build on the momentum of the successful "ban the box" measures, and expand access to capital for qualified justice-impacted individuals.

Additionally, SBA believes that standardizing eligibility rules across all of our capital programs will provide that second chance that many Americans deserve and will help create opportunity to reintegrate into society by pursuing a small business career – investing in our communities and creating jobs. After all, if a lender's credit underwriting team finds that an entrepreneur satisfies their lending criteria, which often involves a detailed search of their criminal history, that qualified person should not be denied a loan due to past involvement with the justice system that may not reflect on the steps they have taken towards rehabilitation and redemption and who they are today.

Thank you for the opportunity to appear before you today. I appreciate your work on behalf of America's small businesses and I look forward to discussing the ways that SBA is working to increase access to capital for underserved borrowers across our nation.

The CHAIRMAN. Mr. Shoemaker.

TESTIMONY OF SHELDON SHOEMAKER, DEPUTY INSPECTOR GENERAL, OFFICE OF INSPECTOR GENERAL, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SHOEMAKER. Thank you. Chairman Cardin, Ranking Member Ernst, and distinguished members of the committee, thank you for the opportunity to be here before you today on behalf of Inspector General Ware.

IG Ware currently is part of a high-level delegation to promote law enforcement partnerships with foreign counterparts in furtherance of rooting out fraud in the pandemic response programs.

I am honored to represent the dedicated men and women of OIG and their hard work as this committee examines SBA's implementation of two recently finalized rules. SBA's final rules rescind the moratorium on new SBLC licenses, remove requirements for a loan authorization, and remove control as an element of affiliation, among other various regulatory changes in the 7(a) and 504 loan programs.

OIG provides independent and objective oversight of SBA's programs and operations. In doing so, our office provides recommendations to SBA leadership to improve the performance of SBA's programs and services for the benefit of the American people.

SBA 7(a) lending program provides financial assistance to small business in the form of Government guaranteed loans. SBA's lending partners in this program where the basis of the Paycheck Protection Program, which delivered vital financial assistance through the lending partners to mitigate economic damage resulting from the pandemic.

There has been no higher priority for our office than providing oversight of the pandemic response. In the past two years alone, OIG's work has resulted in an exponential return on investment to the taxpayer, which is valued at more than $9 billion.

In doing so, we have published 49 reports. Our work also has played a major role in the return of more than $30 billion in pandemic relief funds from borrowers and financial institutions.

This work and our decades of oversight of the lending programs, affirms SBA must take deliberate and intentional steps to design, implement, and operate an effective internal control system as it lifts the moratorium on new SBLC licensors and as the Community Advantage SBLC into the 7(a) program.

When SBA placed a moratorium on approving SBLC licenses in 1982, it did so to reduce the administrative resources needed to prudently regulate and oversee nine depository lenders with a nationwide 7(a) lending platform.

As recent as 2020, SBA stated in its rule aimed at the supervised lender application process, that it does not have the administrative resources needed to increase the number of SBLCs beyond 14 or to oversee their participation in a nationwide 7(a) lending platform. Such concerns are well founded, especially in context of increased risk that are associated with lending authorities available within a 7(a) program, which presently are not authorized by the Community Advantage pilot program.

Concerns also are present in context removal of loan authorization during loan origination. OIG's white paper on risk awareness and lessons learned from prior audits of economic stimulus loans, which was offered by OIG at the outset of the pandemic response, sought to inform the policy decisions in implementing the Paycheck Protection Program.

Among the considerations in this white paper was for SBA to issue clear requirements and ensure timely communication to lending partners. Clear guidance and program requirements following the current rulemaking will enable lenders to participate in the programs with confidence that guarantees are secure if terms and conditions are met.

I have offered additional insights on risk in my written statement that are based on our prior work. We believe appropriate consideration should be given to mitigating this risk as SBA implements these rules.

Solid rules and regulations, strong internal controls, and effective process for oversight and monitoring can mitigate risk and lead to efficiency and effectiveness. Technology also can be a powerful tool in establishing a robust internal control environment for program management, for responsibilities of monitoring oversight, and for regulatory enforcement.

Such efficiencies can augment limited resources. However, technological tools can be limited by availability of essential data. To effectively employ artificial intelligence, comprehensive data must be available and be current.

It is vital where data limitations exist, the internal controls also are not absent and are calibrated in a manner that provides necessary assurance. OIG has an established track record of providing oversight at the inception of new programs, such as the State trade expansion program.

The transparency afforded by our work and our well-founded recommendations for corrective action improve program delivery to the nation's small businesses. The nation once again could depend on OIG to provide independent, objective, and timely oversight of SBA.

Thank you for the opportunity to speak with you today. I am happy to answer any questions you may have of me.

[The prepared statement of Mr. Shoemaker follows:]

SHELDON SHOEMAKER
DEPUTY INSPECTOR GENERAL
U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP
U.S. SENATE

APRIL 26, 2023

Sheldon Shoemaker
Deputy Inspector General
U.S Small Business Administration, Office of Inspector General

INTRODUCTION

Chairman Cardin, Ranking Member Ernst, and distinguished members of the Committee, thank you for inviting me to testify before you today and for your continued support of the Office of Inspector General (OIG). I am proud of the dedication and hard work of the men and women of OIG to not only oversee SBA programs and services, but also to detect, deter, and combat fraud.

Our office provides auditing, investigative, and other services to support and assist U.S. Small Business Administration (SBA) in achieving its mission. OIG's oversight efforts provide recommendations to SBA leadership to improve the performance of SBA's programs and services for the benefit of the American people. The office's investigations pursue evidence of wrongdoing in SBA programs, bringing fraudsters to justice. For the past 2 years, the office is ranked as the top OIG in the federal government as a Best Place to Work by the Partnership for Public Service.

OIG provides taxpayers with an exponential return on investment, rooting out fraud, waste, and abuse in SBA programs. In the past 2 years alone, OIG's work has resulted in more than $9 billion in dollar accomplishments and published 49 reports. Our work also has played a major role in the return of more than $30 billion in pandemic relief funds from borrowers and financial institutions. Dollar accomplishments include investigative recoveries, fines, and forfeitures, as well as review findings of disallowed costs.

OIG strives to continue to deliver on these oversight duties, but we are dependent on the availability of sufficient budgetary resources to address fraud within SBA pandemic response programs. The President has put forward a Fiscal Year (FY) 2024 budget request for OIG to ensure continued oversight of SBA's pandemic response and its vital flagship programs supporting the nation's small businesses. The President also has sought $100 million in supplemental appropriations for OIG, in addition to other measures, for a whole-of-government response to the massive fraud in the nation's pandemic response programs. Absent the total budgetary resources requested for OIG in the 2024 Budget, we will not have sufficient funds to combat the fraud within SBA programs and to provide effective oversight over the agency's flagship programs.

Among these flagship programs is SBA's 7(a) loan program. SBA is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. Participating lenders enter into an agreement with SBA to make loans to small businesses in accordance with SBA rules, regulations, policies, and procedures. The Paycheck Protection Program (PPP) was created under section 7(a) of the Small Business Act to deliver vital financial assistance to mitigate economic damage resulting from the pandemic.

LEVERAGING THE 7(a) LOAN PROGRAM TO EXTEND CREDIT

The 7(a) loan program was created by Congress to help eligible small business owners and entrepreneurs who are unable to qualify for conventional financing secure funds to meet certain business goals, with the overall goal of strengthening and diversifying the American economy. The 7(a) loan program has been adjusted to meet the nation's needs during difficult times, using lenders designated by SBA to finance the program with the backing of the government guaranties in case of borrower default. Though this program is an important resource to American entrepreneurs, with maximum loan amounts up to $5 million, guarantees up to 90 percent, and an annual lending amount of about $35 billion, the program presents significant risk of loss to taxpayers. OIG has a robust body of work to inform Congress and the SBA Administrator of these risks. OIG offers recommendations to improve the efficiency and effectiveness of the program.

SBA has taken steps through pending final rules to expand Non-Federally Regulated Lenders' participation in the program. It is anticipated these lenders will use financial technology companies in a similar way that we saw in the PPP. Financial technology provides these Non-Federally Regulated Lenders and Small Business Lending Companies, which are collectively referred to as SBA Supervised Lenders, with the capacity to reach underserved markets. Highly regulated depository institutions (such as banks or savings associations), which are the backbone of the 7(a) loan program, also use financial technology in making services available to anyone with access to the Internet. With robust internal controls, oversight and monitoring, and enforcement by SBA, risk of loss and costs to taxpayers can be significantly mitigated. OIG's past and ongoing work can inform critical decisions to plan and deliver the 7(a) loan program.

INTERNAL CONTROL ENVIRONMENT

SBA is amending its business loan program regulations to lift the moratorium on licensing new Small Business Lending Companies. The agency plans to add a new type of lending entity called a Community Advantage Small Business Lending Company. SBA also is removing the requirement for a loan authorization in the 7(a) and 504 loan programs. The 504 Certified Development Company Loan helps qualifying entrepreneurs who cannot find traditional financing purchase or renovate real estate or buy heavy equipment for a small business.

In conjunction with removing this loan authorization requirement, SBA is amending various regulations governing SBA's 7(a) loan program and 504 loan program, including regulations on use of proceeds for partial changes of ownership, lending criteria, loan conditions, reconsiderations, and affiliation standards. The goals of these changes are to expand access to capital to small businesses and drive economic recovery. The amendments to affiliation standards are intended to apply to the Microloan Program, Intermediary Lending Pilot Program, Surety Bond Guarantee Program, and the Disaster Loan programs, excluding the COVID-19 Economic Injury Disaster Loan (EIDL) Program.

OIG's oversight work affirms SBA must take intentional steps to design, implement, and operate an effective internal control system as it lifts the moratorium on new Small Business Lending Company participation and adds the Community Advantage lending companies into the 7(a) loan program. Efficiencies sought through the various regulation changes increase risk, which may be mitigated by an internal control system that is fully considered within policy and procedures that implement the rules.

When SBA placed a moratorium on approving additional Small Business Lending Companies in 1982, it did so to reduce the administrative resources needed to prudently regulate and oversee non-depository lenders with a nationwide 7(a) lending platform. These non-depository lenders are supervised by SBA. As recent as 2020 (Final Rule, *SBA Supervised lenders Application Process*, December 4, 2020), SBA stated it does not have the administrative resources needed to increase the number of lending companies beyond 14 or to oversee their participation in a nationwide 7(a) lending platform.

We believe our white paper *Risk Awareness and Lessons Learned from Prior Audits of Economic Stimulus Loans*, published on April 3, 2020, which sought to inform the policy decisions in implementing the PPP, must be considered in context of the actions set forth in the lending company expansion and affiliation rules.

In this Risk Awareness and Lessons Learned White Paper, we acknowledged that SBA has significantly improved its internal control environment in recent years to reduce improper payments and implement quality assurance in its processes. However, recognizing the size and scope of the PPP, we proposed several key considerations for mitigating financial loss when expediting loans to eligible small businesses. The expansion of SBA Supervised Lenders within the 7(a) loan program also requires these considerations. SBA should:

- issue clear requirements and ensure timely communication to lending partners;
- establish and monitor specific outcome-oriented performance measures;
- ensure public communication from SBA officials is appropriate and consistent with the established requirements;
- establish proper controls in the loan approval phase to ensure eligibility of participants and to mitigate the risk of loan default;
- establish a quality assurance plan to prevent and detect improper payments;

- oversee the program to ensure it is implemented as intended and that program goals and objectives are met; and
- modify existing loan systems to track program data to support accurate program measurement and reporting.

OIG believes its body of oversight work, to include oversight of SBA's pandemic response is vital to SBA's approach to implementing these rules. OIG annually publishes its report *Top Management and Performance Challenges Facing the SBA* in accordance with the Reports Consolidation Act of 2000. The management challenges represent areas OIG considers particularly vulnerable to fraud, waste, abuse, mismanagement, or which otherwise pose significant risk to the agency, its operations, or its credibility. Each management challenge generally has originated from one or more reports issued by OIG or the Government Accountability Office. Although we view all challenges as critically important to SBA operations in the upcoming year, we placed COVID-19 economic relief programs first on the list in the 2021, 2022, and 2023 reports.

OIG has identified oversight of high-risk lending participants, and improper payments in the 7(a) loan programs as top management challenges. In 2023, these challenges are noted as follows:

> **Challenge 4: SBA Risk Management and Oversight Practices Need Improvement to Ensure the Integrity of Loan Programs**
>
> Why this is a challenge: SBA's Office of Credit Risk Management (OCRM) manages credit risk for the agency's loan portfolio, and this includes the remaining outstanding loans made through the PPP. SBA's lack of internal controls in PPP led to significant fraud risk and vulnerabilities. Additionally, we found that SBA did not have an organizational structure with clearly defined roles, responsibilities, and processes to manage and handle potentially fraudulent PPP loans. We noted OCRM has the principal responsibility in overseeing such risks within the portfolio. Many PPP loans were originated by lenders and other companies that often have a low degree of expertise in SBA loan program requirements, which was identified as an ongoing challenge for FY 2023.
>
> Lenders often rely on the services of fee-based and other third-party agents to help originate, close, service, and liquidate SBA loans. Most traditional SBA-guaranteed 7(a) and 504 Certified Development Company loans are originated by lenders with delegated approval authority. Generally, these lenders are subject to only limited SBA oversight and quality control unless a borrower default on a loan.

Our previous audits have found SBA has not adequately recognized or managed significant lender weaknesses. In an audit of SBA's oversight of high-risk lenders (Report 20-03), we identified additional internal control weaknesses in lender oversight.

Previous OIG audits have also shown that SBA did not effectively identify and track third-party agent involvement in its 7(a) and 504 loan portfolios. Tracking such agents is crucial in managing the portfolios because many lenders rely on the services of fee-based and other third-party agents to help originate, close, service, and liquidate SBA loans.

Challenge 6: Identification of Improper Payments in SBA's 7(a) Loan Program Remains a Challenge

Why this is a challenge: OIG audits and reviews have identified 7(a) loans that were ineligible, given to borrowers who did not have the ability to repay, or were not properly closed, resulting in improper payments. Improper payments occurred in part because SBA did not adequately review related loans, which is why this remained a management challenge this year.

In FY 2021, the dollar amount of SBA's 7(a) loan approvals totaled $36.8 billion. Most of these loans were made by lenders with delegated approval authority. When a loan goes into default, SBA reviews the lender's actions on the loan to determine if it is appropriate to pay the lender the guaranty, which SBA refers to as a "guaranty purchase." "Guaranty" is a variant of "guarantee" used in financial terminology.

About 8 years ago, OIG established a High-Risk 7(a) Loan Review Program to evaluate lender compliance with SBA requirements for high-dollar, early defaulted 7(a) loans. High-dollar, early defaulted loans are $500,000 or more and default within the first 18 months of initial disbursement. The 7(a) loan program has been the agency's largest financing program for general business needs; therefore, it is vital that SBA identify and reduce the risk of improper payments in order to meet its objectives for the program.

KEY RISK CONSIDERATIONS OF SMALL BUSINESS LENDING COMPANY EXPANSION

SBA has stated that the lending company moratorium has been in place principally because of the administrative resources needed to administer and regulate an expansion beyond the existing 14 Small Business Lending Companies. Such concerns are well founded, especially in context of increased risks that are associated with lending authorities available within the 7(a) loan program, which presently are not authorized by the Community Advantage Pilot program. Removal of the Loan Authorization as part of loan origination also gives rise to a concern within our Risk Awareness and Lessons Learned White Paper —it is necessary for SBA to issue clear requirements and ensure timely communication to lending partners. Clear guidance and program requirements will enable lenders to participate in the program with confidence that guarantees are secure if terms and conditions are met.

OIGs oversight, such as in this situation, helps guide SBA in its efforts to institute a robust internal control environment.

Risk of Default

OIG's Report 20-08, published in March 2020, found the default rate for Community Advantage Pilot Program loans approved between FY 2011 and 2016 exceed 14 percent. Over the same period, the default rate for similarly sized non-Community Advantage 7(a) loans was 8.7 percent. SBA has proposed for lenders to rely more heavily on credit scores, as opposed to more stringent underwriting. Additionally, SBA has proposed reliance on lender credit policies in lieu of an SBA standard. Concerns noted during the rulemaking effort were offset by SBA comments that it reviews credit policies as part of application to become an SBA lender.

Risk of Loss through Increased Maximum Loan Amounts

The Community Advantage Pilot has a maximum loan amount of $350,000. SBA's pending rule is silent on the maximum loan amount. Aligning the Community Advantage Small Business Lending Company program requirements with 7(a), absent any specified restrictions, would allow for loans up to $5 million. Increased dollars equates to increased risk to the taxpayer, particularly since the basis of SBA's 2020 Small Business Lending Company rulemaking sought to address loan loss reserve concerns associated with such large loans.

Risk of Insufficient Oversight and Monitoring

SBA Supervised Lenders are regulated by SBA, as opposed to banking regulations and insurances. OIG Report 23-05 has highlighted staffing within the Office of Credit Risk Management (OCRM) as an area of risk, which is especially significant in context of the stated basis of the 40-year moratorium—necessary administrative resources. Such resources also would be needed in lender application reviews relative to credit policies and continuing oversight of this important program aspect.

> OIG Report 23-05 identified factors that could impact the 7(a) loan program and should be considered in SBA's program risk strategy. Specifically, in FY 2021, the total amount of loans increased to $31.4 billion from $19.4 billion in

FY 2020 (62 percent increase) and $20.6 billion in FY 2019 (53 percent increase), as did the average loan amount. Loan approvals decreased in FY 2020 and returned to pre-pandemic levels in FY 2021. Default and charge-off rates also significantly declined after implementation of the Coronavirus Aid, Relief, and Economic Security Act.

Oversight staffing levels within OCRM decreased from 42 to 26 employees, or by 38 percent. This staff reduction could affect SBA's FY 2023 goal for oversight reviews, which help ensure lender compliance with program requirements. The relief payments likely attributed to declining default and charge-off rates. Small businesses also had access to additional support during the COVID-19 pandemic, which included the PPP, the Restaurant Revitalization Fund, Economic Injury Disaster Loans, and deferred 7(a) loan payments. However, variable interest rates for 7(a) loans increased because the base prime rate increased from 3.25 percent to 6.25 percent in 2022. The effects of the pandemic combined with the rising interest rates could increase the risk for subsequent defaults and charge-offs. These program trends could increase SBA's liability and have a negative impact on its ability to achieve its zero-subsidy rate goal.

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

Risk of Other Than Small Businesses Accessing Credit Programs

SBA's pending affiliation rule indicates, "The determination of affiliation is necessary to ensure that an applicant is 'small' for purposes of eligibility for SBA financial assistance and to ensure that the applicant (including affiliates) does not exceed the maximum guaranty amount available." However, SBA's rule is specifically removing the principle of control of one entity over another as a separate basis for finding affiliation. The stated reason is "because the concept of control as it exists requires understanding and expert consideration of business entity relationships well beyond what is owned by the applicant business or its owners."

OIG's Report 18-13 found that 7(a) loans made to chicken 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 our office 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.

> 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. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

OIG's findings in this review hinged on the concept of affiliation through control, and in the SBA pending final rule, this affiliation criterion is removed. Without a requirement to consider control as an affiliative component, a lender potentially would simply view the chicken grower as the owner, absent any subsidization that the 7(a) loan would provide to the operations of the large companies that are controlling the chicken grower's business.

The rule also removes being a franchise as an element to consider as a basis to assess affiliation. The rule states SBA is removing pre-approved franchises that do not have affiliation as determined by SBA. SBA's approved franchise list assisted lenders by not having to conduct a control assessment on a loan-by-loan basis for identified franchises. Our Report 13-17 found that franchise loans are a high-risk segment of the portfolio, and our recommendations focused on portfolio risk management by SBA.

TECHNOLOGY

Data analytics has been essential to OIG's pandemic oversight efforts. In the fall of 2022, OIG took a significant step by establishing its Technology Solutions Division, which aligns with our objective of "leveraging technology and employee experience to improve OIG methods in carrying out our mission." Through intentional investments in data analytics, OIG's data analytics team has been able to use machine learning and artificial intelligence to identify outliers in the portfolios for investigation, as well as employing traditional data analytics to develop investigative leads for our special agents working in tandem with task force partners.

Our enhanced data analytics capabilities allow OIG to use data matching to expose potential fraud rings rather than investigating potential fraud on a case-by-case basis. To date, OIG's data analytics have identified billions of dollars in potential fraud in SBA's pandemic response lending programs, and this capability is central to our ongoing work to identify the emerging fraud landscape. Additionally, with the hundreds of thousands of allegations of wrongdoing reported to the OIG Hotline and through our data analysis efforts, our ability to handle them is only possible through robust data analytics tools. Of the more than 240,000 Hotline complaints we've received, our data analytics team identified more than 86,000 actionable leads, which alone represents more than 100 years of investigative case work.

Such technology can be equally powerful in establishing a robust internal control environment for program management and the program responsibilities of monitoring and oversight, and regulatory enforcement. Such efficiencies can force multiply the impact of limited resources. However, such tools can be limited by the availability of data. Although SBA and OIG have statutory and regulatory access to loan files, corresponding loan information within SBA's Capital Access Financial System, which includes E-Tran for loan origination and servicing is not comprehensive. To effectively employ artificial intelligence, comprehensive and reliable data must be available and be current. Where data limitations exist, it is vital that internal controls also are not absent and are calibrated in a manner that provides necessary assurance.

As an example, our pandemic response oversight found a concern where reliance on technology resulted in improper payments and potential fraud.

> OIG's Report 22-17 evaluated SBA's controls to flag or prevent potentially fraudulent COVID-19 EIDL applications submitted from foreign Internet Protocol (IP) addresses. Although the agency implemented several layers of controls to prevent or reduce fraud from foreign countries, individuals at foreign IP addresses were able to access the COVID-19 EIDL application system. SBA received millions of attempts to submit COVID-19 EIDL applications from foreign IP addresses and stopped most of them; however, the agency processed more than 233,000 of these applications from March 20, 2020 to November 12, 2021, our review period. Of this amount, SBA approved and disbursed 41,638 COVID-19 EIDLs, advances, and grants for $1.3 billion.
>
> The numerous applications submitted from foreign IP addresses are an indication of potential fraud that may involve international criminal organizations. OIG has ongoing investigations into international organized crime operations that applied for and stole pandemic relief funds. SBA officials were aware of and concerned about the potential fraud from overseas. We recommended that the agency examine controls related to foreign IP addresses and ensure these controls are more effective in future disaster processing systems among other recommendations for corrective action.

CONCLUSION

OIG's prior work has identified areas of risk in SBA's 7(a) loan program. SBA has made significant progress in addressing the identification of improper payments in the 7(a) loan program and continues to make progress in risk management and oversight practices within OCRM. OIG's ongoing oversight will continue to promote integrity, efficiency, and effectiveness it these areas.

SBA's pending final rules to rescind the new Small Business Lending Company moratorium, and to remove loan authorization and affiliation controls have associated risks. Our work has increased transparency on these significant risks and inform the program decisions under consideration today. Solid rules and regulations, strong internal controls, and an effective process for oversight and monitoring can mitigate risk and lead to efficiency and effectiveness.

OIG will continue to shine the light of transparency on areas of concern and will be the independent and objective voice in our service as a valued change agent. The President has put forward a FY 2024 budget request for OIG to ensure continued oversight of SBA's pandemic response and its vital flagship programs supporting the nation's small businesses. The President also has sought $100 million in supplemental appropriations, in addition to other measures, for a whole-of-government response to the massive fraud in the nation's pandemic response programs. Absent the total budgetary resources requested for OIG in the 2024 Budget, we will not have a sufficient operating budget to combat the fraud within SBA programs and to provide effective oversight over its flagship programs, which includes the 7(a) loan program.

The CHAIRMAN. Well, let me thank both of you for your public service. Thank you very much for being here. And thank you for the role you are playing on behalf of small businesses.

Mr. Kelley, I appreciate your testimony in regards to going after those who have committed either fraud or mistake. That is something that was really the subject matter of our last hearing. This hearing, the subject matter of the two rules that have been promulgated.

And I am somewhat disappointed that your statement doesn't really address that rule. It is more dealing with the fraud issues than it is the rule that is before us on this hearing.

So let me try to drill down a little bit. This rule is going to take effect in two weeks. When do you expect the SOP to be available?

Mr. KELLEY. I think our deadline right now is May 3rd, or in and around that date.

The CHAIRMAN. And can you tell me why the rule? How do we guarantee that we are going to see loans to small businesses, smaller loans? How are we going to guarantee that the CA lenders are concentrating in underserved communities?

How are we going to assure CA lenders are borrowers of the cost of the loans or the underwriting rules? I don't see that in the rule itself.

So, if I am a CA lender, what confidence do I have that this program is really geared towards my mission, which is to provide help in underserved communities and smaller, or small loans.

What assurance do I have that someday it won't be turned over to the larger loans, as we saw what happened with the 7(a) program?

Mr. KELLEY. So first, as Administrator Guzman did share with you and we shared with staff, we intend to put in the SOP and you will see reflected the 60–40 rule that was reflected in the Community Advantage Program guide.

We have also discussed with your staff your bill, the Cardin-Chu bill calls for a 70–30 ratio. One of the reasons that Administrator Guzman did not put a 60–40 requirement into the rule is because, as she shared with you and members of the committee, the current definition of underserved does not include women or minorities.

And so, any definition of underserved, I think in the room, would include those two bodies, most especially since African Americans represent 12 percent of the population, they represent 41 percent of sole proprietors, and they see 2 percent currently of 7(a) loans.

And so, for example, when my counterpart here in the private sector, Hilda Kennedy, testifies of her lending in California, if her shop wanted to focus on meeting that underserved gap regardless of income level, she would not be able to focus exclusively on that as a mission-based lender. And it is the same for women who are underrepresented as well in the seven loans for the same thing.

The CHAIRMAN. So, I am a bit confused. You are saying you didn't want to put anything in here to protect the mission and to the rule itself because basically court concerns about target groups.

So, we have had a program that has been successful. The CA program has worked with the guidance on a percentage of loans in underserved communities, and you are throwing that out and saying we are not going to have anything in the rule but trust us. Is that what I am hearing from you?

Mr. KELLEY. No. That is not what you are hearing. So, in the 7(a) program, all lenders make 50 percent of their loans to the current definition of underserved.

So, the current definition of underserved is rural, low to moderate income, hub zone startup, those businesses in business less than two years, and veteran owned businesses. So regardless of lender type, regardless of loan size, roughly 50 percent of the loans——

The CHAIRMAN. Which is not in this rule, is it?

Mr. KELLEY. I am saying you are correct. It is not a requirement of the rule. And yet every year the lenders, through their lending activity by nature of the——

The CHAIRMAN [continuing]. But that is the pilot program—that is the CA pilot program.

Mr. KELLEY. Correct. But the—what I am explaining is that if you did not have a 60–40 percent threshold in the Community Advantage program like we do not have in the 7(a) or the 504 program, when the lenders are making their loans, the outcome, the outcome of the loans, the standard 7(a) express 504 loans ends up meeting the underserved definition that is defined in the Community Advantage, 50 percent.

What is better in the Community Advantage Program is the loans to women and minorities. But in that definition, they do not get credit in the 60 percent threshold of meeting that 60 percent——

The CHAIRMAN. But they are meeting—look, the communities—the Community Program is working. We have the 60 percent and we also have the penetration to the target groups who would like to get the loans. And the loans are also smaller dollar amounts and are also costing less. But none of that is in the rule.

Mr. KELLEY. Yes. So, as I explained to you, and Administrator Guzman explained to you as well, we are putting that 60 percent—40 percent threshold in the SOP. Each lender is responsible for executing the form 750.

The first line or first two sentences of that form, the form 750 requires that the lender comply with all statute, all regulation, and all SOP guidance regarding the rules.

The CHAIRMAN. What assurance do I have as either a lender or a borrower about the cost of a low—a small loan which is competitive under the CA pilot program but not necessarily under 7(a) program? What assurance do I have on costs? Is there something in the rule that I haven't read?

Mr. KELLEY. When—so are you referring to rate and fees of a 7(a) loan or are you referring to the capital requirements, the fidelity insurance requirements?

The CHAIRMAN. I am really referring to both, but right now I am talking about the cost of processing.

Mr. KELLEY. Okay. So historically, Community Advantage lenders have always enjoyed a higher interest rate than standard 7(a) lenders. Most recently, we promulgated rules to standardize that for all lenders. And so——

The CHAIRMAN. Is there something in this rule that I can look at that says that we are protecting the 7(a) CA program on costs, processing costs?

Mr. KELLEY. Yes, so——

The CHAIRMAN. It is in the rule?

Mr. KELLEY. So, the rates themselves are in——

The CHAIRMAN. Processing costs, I am talking about.

Mr. KELLEY. Yes. Okay. So, then that is the fidelity insurance and capital requirements and loan loss reserves. So, for example, in the Cardin-Chu bill, you do not call for a capital requirement threshold or a fidelity insurance threshold. So let me explain——

The CHAIRMAN. Are you supporting the statutory approach of our legislation?

Mr. KELLEY. We are absolutely—we were directed by Administrator Guzman to, after working with your staff on Build Back Better regarding making Community Advantage permit, to look for the areas where your bill could direct us in a way that would make the Community Advantage program stronger.

So, for example, in your bill you call for a 5 percent threshold for the loan loss reserve requirements, which allows for over 36 months of performing loan performance for that loan loss provision to come down.

The CHAIRMAN. Are you supporting us statutorily passing legislation to make permanent CA program similar to the legislation that has been—was filed? Are you supporting a statutory approach or not?

Mr. KELLEY. I would support anything that helps Community Advantage lenders with their mission.

The CHAIRMAN. I will take that as a yes. Senator Ernst.

Mr. KELLEY. Good.

Senator ERNST. Mr. Chair, Senator Risch does have another commitment, so I will yield my time to him.

Senator RISCH. Thank you, Mr. Chairman and Ranking member.

First of all, I was hoping Ms. Guzman herself was going to be here because I wanted to thank her and congratulate her by accomplishing something that is very, very seldom done around here, and that is bringing Republicans and Democrats together to oppose what they are doing on this thing. This is a disaster in the making.

What shocked me was—I mean, we were treated like chopped liver around here. Guzman told us, oh, they are going to pay close attention to the concerns that we have. And less than just ten business days later, they announced that the rule was moving forward without any consideration of what this committee input that is put in here.

Look, the financial industry—if you were in front of the Banking committee, I think they would be taking your head off here. The banking industry, the financial industry needs really close oversight regulation.

I am no fan of Government regulation, but when it comes to finances, this country has learned over and over and over again with the banks—start with the savings and loans disaster that we had. If we aren't looking over the shoulder of the lenders, this is a disaster waiting to happen. And that is exactly what you are doing bringing the fintechs in here.

We certainly should have learned this from the PPP program. All of us knew when we voted for that, that it was—we were taking a chance because of the know your customer was going to be out when there were too many customers. And that is exactly what you are headed for here. I would hope that you back up on this.

I suspect you are going to be facing the CRA if you don't. Probably a bipartisan CRA if this regulation comes down the pike. But you know, the—one of the things that struck me is you are Fiscal Year 2022 goal for 7(a) loans to underserved markets was how much? 43 percent. Do you know what the actual production was on it? It was 68 percent.

So, there is no failure here. I mean, you far exceeded the goals of what you were trying to do. So, I am not sure who the geniuses that brought this up, but I wish you guys to take this back to the drawing board and listen to us. I think Senator Cardin is right.

I think, you know, we trust the agencies generally to do the kinds of things that we don't have time to do. It looks to me like we are going to have to take the time to do this, and I agree with you, Mr. Chairman. I think this is going to take a statutory answer to this.

I have some very specific questions for the record, and if it is okay, I will submit those, Mr. Chairman.

The CHAIRMAN. Certainly. Thank you. Senator Hirono.

Senator HIRONO. Thank you, Mr. Chairman. I take it that the concerns being expressed by my colleagues regarding these new rules also have to do with whether or not there are enough protections in the new rules to guard against fraud. Is that correct, Mr. Chairman?

So, Mr. Kelley, what is in these rules that is different from what happened during the CARES Act provision, which, by the way, we did not—it is not as though Congress put in a lot of resources for SBA to do this stuff. We just sort of said, here, go and do it.

So, in these new rules, what kind of anti-fraud measures are in the rule, briefly?

Mr. KELLEY. So, the moratorium allows a lender to participate in the 7(a) program. And as such, they comply with all the statutes, regs, and SOP related to 7(a) loan.

So, for example, what was different—what is different about a 7(a) loan than a paycheck protection loan program? First off, there is underwriting. Second, there is collateral.

Third, there are personal guarantees for any owner of 20 percent or more. And then what I indicated in my testimony and the reason I began with the CARES Act programs is because I wanted the committee to understand one of the major lessons that we did take away at the agency from the challenges that the Biden-Harris Administration inherited with respect to fraud in the CARES Act programs, and that was that if we need to do speed and certainty both, not just speed.

And certainty requires that we put in place systems that will screen automatically before we disburse the money. The notion that you can go get the money after it goes out the door was never a real strategy.

So, what we are also putting in place with this SOP for the first time is for all delegated loans, all non-delegated loans, any loan that is going to be originated across 7(a) and 504 and we did this in PPP three, we will be screening 19 different categories of eligibility and fraud.

And if there are alerts and flags, which there were in POP three and there were in COVID EIDL, then we will move to determine whether there is a false positive, meaning it was an error and the person can move forward and demonstrate that that was a false signal.

Or if not, we will prevent that from moving forward. And what that addresses in the audit reports that we share and that they provide feedback for us, is the notion of improper payment related to ineligible loans or reasonable reassurance of repayment.

Senator HIRONO. So, Mr. Kelley, you are telling me that there are many checks, many more checks than that were in place during the whole PPP and EIDL and those programs, because we directed you to put all this money out there in the community during a very challenging time for our small businesses. Is that correct?

Mr. KELLEY. Yes, it is.

Senator HIRONO. It sounds like. Okay, good. Then, did I hear you say that the definition of underserved do not include women and minorities owned businesses?

Mr. KELLEY. Correct.

Senator HIRONO. So that is a change, isn't it, that you are making?

Mr. KELLEY. No, it is not—it is not a change. It is never included. It has never been included.

Senator HIRONO. Why wouldn't you include minority owned businesses as underserved in the underserved group?

Mr. KELLEY. The agency under the Obama Administration, when we created the Community Advantage program in 2011, determined that using class, race, and gender as a differentiator would not be considered Constitutional.

Senator HIRONO. Has that been tested in court?

Mr. KELLEY. Well, we were sued, as you know, in the Restaurant Revitalization Program, where we had economically and socially disadvantaged and women as a priority applicant.

And two injunctions were issued by two different courts. So, it has not been directly tested because we have not included it, but it was tested in the Restaurant Revitalization Program. And that is one of the reasons that you do not see in the definition.

So the point I was trying to make to Chairman Cardin—I didn't do a good job and I know we are in align on this, but I am doing a bad job communicating, is that when we think of my friend back here, Hilda Kennedy, who is going to testify in the next panel for Accion, for the other guy, their focus is in these marketplaces, rural women, minority borrowers.

And from the Administrator's perspective, she does not believe that mission-based lenders are going to forget their mission when they go to lend. And she wants to make sure that they are not ever in a position where they are non-compliant with our threshold because they want to originate 100 percent of their loans for women, for example, women entrepreneurs.

Senator HIRONO. So, I understand that you do have some legal concerns, but when we are talking about wanting to expand access to capital for minority owned businesses, that speaks—that says to me, you obviously have information relating to black owned businesses.

I would like to know whether you have any data on hispanic owned businesses, Asian-American businesses. There are thousands of small businesses in these categories, but you are saying that you have a concern about keeping track of the kind of loans that are made to these groups of businesses, of which there are thousands, and they are not all in hubs or all in rural areas, or whatever other categories you have.

Mr. KELLEY. Yes. So, what I am saying is, is that that data today is—has always been voluntary.

The CFPB 1071 rules that have just been passed, which to my friend from Idaho with respect to the Banking committee, the banks were not in favor of 1071 for reporting, right, but that is a rule that is going to give us transparency on this very issue.

And the further point that I am trying to make for Administrator Guzman is that because there is a question of Constitutionality in the minds of the Biden-Harris Administration, the Trump Administration, and the Obama Administration, three different Administrations that kept the Community Advantage Program alive and did not include those definitions that, we think we might be undermining the mission based focus on race and gender, which we totally agree violently agree that is where the true gap is.

So, this would be, to Chairman Cardin and Ranking Member Ernst, in their desire to pass a law to make Community Advantage permanent. If Congress wants to make the underserved definition to include race and gender, which, for example, we worked with Senator Cardin's staff on Build Back Better, it would have, then we will implement the law as it is passed.

But from the standpoint of the beginning of the Community Advantage Program to now, that definition has not included those.

Senator HIRONO. Okay. Thank you, Mr. Chairman. I think you should think about including race and gender as factors.

The CHAIRMAN. Senator Ernst.

Senator ERNST. Thank you, Mr. Chair. And as you can see, there is a lot of concern across the board about our discussion at the last hearing and the issues that were raised by the Senators on this committee.

I know there are concerns in the House as well about the issues with the rules, and yet no changes were made to those rules. So, Mr. Kelley, I am concerned you started making calls to stakeholders to garner support for these rules when you noticed that they weren't receiving support.

At any point during the rulemaking, did you conduct outreach or have discussions with stakeholders that was not made public and part of the rule's records, yes or no?

Mr. KELLEY. The—did we conduct outreach? Yes, we made all of the folks available—all the folks aware that the rules were available. We conducted staff meetings with Senator Cardin, for example, with members of different Community Advantage working groups.

There was various, Now CAB, other groups as well who provided feedback. And then that feedback was reflected in the public written record as it was put forward.

Senator ERNST. So, okay. So, you did have discussions with stakeholders and it was made public.

Mr. KELLEY. Yes, I believe so.

Senator ERNST. And part of the rules record?

Mr. KELLEY. I believe so.

Senator ERNST. Did you make any promises or commitments concerning the standard operating procedure documents or agency procedural notices in order to garner support for these rules, yes or no?

Mr. KELLEY. In order to garner support, no.

Senator ERNST. Will you provide the committee with copies of your schedule, phone logs, and email communications during the rulemaking period.

Mr. KELLEY. I will do that—as you know, all of that information is the agency's property and working with the committee, you can submit a request——

Senator ERNST. So, yes.

Mr. KELLEY. But I think for full transparency, as Senator Cardin's staff understands and knows, and as we have alluded to in these discussions, Administrator Guzman had discussions, as is mentioned, with all of members of the committee regarding the rules and the feedback and regarding the public comments that had come in.

And we discussed the public comments that were in the public record with various members about their concerns and their questions to amplify whatever they had already raised in the public record.

Senator ERNST. Okay.

The CHAIRMAN. I just want to point out, I am not sure Mr. Kelley can fully answer that question. These are legal issues that I would want the SBA to be able to work with us to get the information that we need. So, I recognize that is a question that may not be under your specific decision making.

Senator ERNST. I would also—thank you, Mr. Chairman. And I also would want to know, of course, if there were discussions with stakeholders outside of Congress as well.

Moving on from that, the SBA under your direction ended debt collections on $1.1 billion worth of unforgiven PPP loans under $100,000, and according to the Inspector General, is planning to do the same with about $71 billion worth of COVID emergency disaster loans, or the EIDLs.

So, I sent a letter to Administrator Guzman on this EIDL decision, and I did receive a response, but I consider it an insufficient response. And that response came this morning, conveniently today as you are testifying. The letter failed to answer any of my questions.

So, let's make sure we are setting the record straight, Mr. Kelley. Is SBA going to pursue debt collections on EIDL program loans under $100,000? And have you reached out to every borrower to confirm their ability to repay these loans?

Mr. KELLEY. Yes, we have. And I would like to clarify this, too, because it is important that we don't mislead borrowers. Every single borrower of PPP loan and every single borrower of a COVID EIDL loan must repay the loan.

If they do not repay the loan, they were referred to credit bureaus. If they do not pay the loan, they are referred to Treasury, do not pay. The decision we made with the law—the law calls for the agency to make a cost benefit analysis for instances under $100,000, where the cost of administering the Treasury offset would be higher than the recovered dollars.

And we looked at the costs, which it was estimated to cost about $6 million to collect $3 million on that $1.2 million—or 1.2 billion or 77,000 PPP loans. And that is because when we took a more conservative loan portfolio snapshot, we took 2009 to 2022, loans that had been underwritten, loans that had personal guarantees, loans that had all available collateral but could be unsecured, and we looked at what Treasury offset wage garnishment had collected, in that 13-year period, had collected $65,000.

We had no personal guarantees. We had no underwriting. We had no collateral. These were all by design. These were not bugs. These were features of these programs. And so, after someone has not made repayment and the lender has taken the servicing and liquidation action that they can take, they seek purchase.

And when we estimated the cost of pursuing Treasury offset, or TOP, it would cost us more than the money we would collect. And that is why we opted to stop that so that we didn't waste $3 million of taxpayer money.

Senator ERNST. Mr. Kelley, I don't think it is a waste to ask Americans to repay loans that they signed——

Mr. KELLEY. We are asking them to repay. We are not—we are—I want to make this really clear. We 100 percent, I want everyone watching at home on C–SPAN, you must repay your loan.

If you do not repay your loan, if you do not seek forgiveness, incidentally, if you miss 60 days of nonpayment in the PPP Program by design, ratified by the Economic Aid Act, you still have up to five years to come back and seek forgiveness.

So, we would be referring to Treasury debt. You are then allowed to have an administrative hearing as a member of the public regarding that before that wage offset kicks in.

That costs the agency $700,000 in fees. You then can seek forgiveness for which under $100,000, by law, under the Economic Aid Act, you need to submit a one-page form to the lender who then services the forgiveness decision.

So, repayment is 100 percent required. We will put them in Treasury do not pay, which means that they are barred from seeking any other aspect of Federal programs until they make the Government whole on that.

They are referred to the credit bureau, so their credit score goes down and we should make a distinction as well. If anyone is an LLC, s-corp, or c-corp and they borrowed money, less than $100,000, they can enter into bankruptcy. And because the program did not require any personal guarantees, they will be discharged.

And because we are in subordinated position as a result of the program, we don't have any standing in order to recover anything from the senior debt holders. So, repayment is absolutely required. We are doing everything, as are the lenders, to get repaid.

We have forgiven 10.6 million out of 11.4 million PPP loans to date. And as you know, the taxpayer already gave 103 cents on every PPP dollar to either be used for purchase or for forgiveness. So, the only step that we are foregoing seeking is where we are going to lose $3 million more dollars of taxpayer money.

The signal is not that we are telling you not to repay. We are absolutely telling you repay. But when we decided as a country, Congress and the Executive Branch, that we were going to provide emergency relief and we weren't going to require any of the safeguards that are normally associated with these loans, that was going to impact our ability to collect on the back end, which is why the subsidy rate was 103 cents to 100 cents.

So, it is important that we will absolutely seek repayment.

Senator ERNST. Well, and I know we need to move on, Mr. Chair, but I think the message is out there, though, that we are not doing everything we humanly can. We would rather not spend the $3 million. It is just like the charlatan that went after your grandmother on the phone issue——

Mr. KELLEY. That person got away. In the case of the PPP program, we have identified the folks that either attempted fraud or committed fraud and we have referred them to the IG so that we can all go get them. That is the distinction.

Senator ERNST. Thank you. And we will go ahead, Mr. Chair.

The CHAIRMAN. Thank you. Senator Hickenlooper.

Senator HICKENLOOPER. Thank you, Mr. Chair. Associate Administrator Kelley, nice to see you again. I know that the SBA is only adding three additional SBLC licenses at the moment on top of the 14 licenses successfully managed for 30, 40 years, I guess, as part of its rulemaking.

However, many of the comment letters on the SBLC's final rulemaking have argued that removing the moratorium completely risks the—risks letting too many firms into the program for the SBA to be safely able to manage it.

Are you willing to commit to only adding additional SBLC licenses once and only after the SBA has conclusively demonstrated it can provide appropriate oversight of the new SBLCs?

Mr. KELLEY. Yes. So, we indicated the reason that we didn't, and we indicated this in the proposed rule, and that we felt we had the capacity to take on three additional lenders.

And I think what is important to understand is that in the 40-year history of the SBLC licenses, there has been 14 licenses. Those licenses have been available for sale for that entire 40-year period and have transferred 61 times.

Each time there is a transfer, you need to—the buyer and seller need to apply to the SBA. There is a process written out in the SOP in the standard operating procedures. It has been there. It is not changing. It is not going anywhere.

You apply when the application is reviewed. So, when we look to see whether the buyer should be approved from the seller, we look at the safety and soundness.

We look at their portfolio history. We look at their business plan approach. We look at whether or not they comply with all of the rules that they need to comply with as an entity. So, for example, State user laws. We look at Bank Secrecy Act and those types of things.

So, all of those things are put into consideration today that was in existence when we were growing the Community Advantage program up into the moratorium.

And that program, the high water mark of that program was 130 entities. It dropped down post moratorium through attrition to the low nineties and has since moved up to 108 entities.

So, when we looked at the existing capacity, we looked at the oversight headcount. We see exactly what you see. Administrator Guzman, I, we all share the same concerns. We looked at the fact that we had the capacity under the ceiling and we set it at three because we understood clearly that we were going to be doing something different.

But we should make no mistake about the following either. And I think it was a great point that Chairman Cardin and Ranking Member Ernst brought up. You know, how do we know that these lenders will make small dollar loans or how do we know that these lenders will fill the gap?

Why are we not asking the same of the lenders who have participated in the program for years? We have not—we have not been called on to require a quota for any of the banks or credit unions.

Credit unions make 500 loans a year in the SBA program, and yet there are north of 5,000 institutions out there. In the 90s, credit unions explained, against the bank wishes, that they were going to grow access to capital by serving underserved needs, and yet their average daily balance to high-net-worth individuals has grown.

So, each time we look at these institutions, we are keenly aware that the lending intermediaries that we work through can make choices. But I don't know why we are limiting ourselves to being concerned about the lenders who in the marketplace are showing time and time again that they have created a comparative advantage.

They think their business model is competitive and we are going to give them a conforming product, a product that has transparent terms, better amortization periods, better rates, better fees, and that is the only thing that they can originate.

And as I said in my opening testimony, we can screen now, prior to each brand authorization, with digital tools, we do random audits of those files every time they file.

So, to Ranking Member Ernst's concern, every time they make a bad loan, and Deputy Inspector General can echo this, if they make a bad loan in less than 18 months as an early default, it is referred to the Inspector General as well as us, and we look to repair and deny the guarantee.

So, I think that we—I just want to make everyone aware that we completely agree with all members, bipartisan, that this is a thing that has to be taken soberly, has to be taken seriously.

And we believe that we have systems that we have developed over time that can support that. And yes, we are going to move slowly. We are going to move judiciously to get it right.

Senator HICKENLOOPER. Good. I think the question, which I think you have answered, is that we want to make sure that there that we are not losing anything in the transition, and that somehow the having the barn door open a little bit isn't going to lead to some level of, you know, uncontrolled transformation.

And I am that is not a worry of mine. I think that you have demonstrated that you have the capacity to administer the program properly and that you are going to do so cautiously and expeditiously. I yield back, Mr. Chair.

Senator SHAHEEN. Thank you. Senator Budd.

Senator BUDD. Thank you, Chair. Again, thank you both for being here. Mr. Kelley, I want to go back to a previous conversation you had with Chairman Cardin. Can you clarify of the 60, 40 split in the SOPs that applies to all lenders or just the SBLCs?

Mr. KELLEY. So currently right now, the 60, 40 requirement is in the Community Advantage program only.

And so what I shared with Chairman Cardin, now I will repeat for you, Senator Budd, is that roughly 50 percent, right, in a given year of 7(a) loans and 504 loans, regardless of size and regardless of lender touch, the definition of underserved—and the definition of underserved includes low to moderate income, hub zone, startup, those businesses in business less than two years, and veteran owned businesses, and rural.

Senator BUDD. So that is 50 percent?

Mr. KELLEY. That is roughly 50 percent. Yes, there is—give or take. And so, my point to Chairman Cardin was that if minorities are seeing less loans or women are seeing less loans, then the census track is demonstrating that they are sole proprietor.

So sole proprietors, as you know, seek smaller dollar amounts, right, by definition, right. And so, if those types of entities overindex, which they do in the census track, to minorities and women, and we are not seeing—when we are seeing a five-year decline of like 45 to 50 percent in terms of small dollar lending, then the outcome that is created by that, right, is that you are going to see less loans, right.

And if those there are less loans to sole proprietors, you are going to see a disproportionate impact, right, or a disparate impact on classes that are overrepresented in that type of entity type.

So, our position is that when we are choosing lender intermediaries, the whole point—I was there at the beginning of the Community Advantage, but the whole point of the Community Advantage Program was, don't try to figure out for the private sector entity how to—figure out the business model.

They have established their business model. They are already showing you that they have a market niche for whatever their reasons are. That is how they make their money and that is how they serve their thing.

And in the case of mission based CDFIs, their primary focus is often rural, veteran, minority, women, and they have all different types of strategies.

And so, if we allow them to use the same tool, then they will reach a customer and they will enjoy the benefit of that tool no different than the bank or credit union that has enjoyed exclusivity historically.

Senator BUDD. Thank you for that. Mr. Shoemaker, thanks for being here. You know, some of the rules that have been discussed today would allow the SBA Administrator to review reconsideration of denial requests and make a final decision without transparency or justification.

In other words, it provides the Administrator with the sole power to grant 7(a) loans or—regardless of the credit creditworthiness of the loan applicant.

Mr. Shoemaker, should the SBA be required to be transparent to both borrowers and lenders by providing written justification when making final decisions on reconsideration of denial requests?

Mr. SHOEMAKER. Certainly, transparency is a key. In regard to whether or not the Administrator has the authority to do the reconsideration, certainly there is always the chain of command that gets to that level. I believe that is actually already in place, that she has that ability to make that decision—if you want, but go ahead—thank you——

Mr. KELLEY. Yes. So, yes, for reconsiderations, we do—so, for example, in the COVID EIDL program, all folks that were denied and were seeking reconsideration received a written justification for, you know—and we improved in the summer of 2021 the explanations of things that they need to do to cure—yes——

Senator BUDD. Mr. Shoemaker, and follow up if we needed, Mr. Kelley. Should the SBA Administrator have the authority to force a lender to provide a 7(a) loan regardless of the credit worthiness of the borrower, or if the application may be fraudulent or improper?

Mr. SHOEMAKER. Again, the Administrator does have the authority to make the loans. I certainly wouldn't advocate for a loan——

Senator BUDD. This is about forcing a lender to provide the 7(a) loan.

Mr. SHOEMAKER. Sure. So, I wouldn't advocate for a loan that has any of those poor standards to be put out in the—expose the taxpayer to that risk.

Mr. KELLEY. And speaking on behalf of the Administrator, no, we would not want to force a lending intermediary to make a loan that they don't want to make.

Senator BUDD. Thank you. I yield back.

Senator SHAHEEN. Thank you. Mr. Kelley, the SBA played a critical role during the pandemic. I think we could all agree with that. And the benefits are still out there.

We have seen a record number of new small businesses being formed over the last two years. But I am concerned that the recent affiliation rules that the SBA just finalized will allow larger companies and to your loan programs. So, can you explain the rationale for that?

Mr. KELLEY. Yes. And I encourage you, if you are able, in the second panel, Hilda Kennedy is testifying and she is part of a certified development corporation, serves on the board of Nabco, which I am sure you are familiar with as a trade association.

Granite State is obviously a huge player in the 504 program. Beginning in 2011, during the Obama Administration, members of the National Association of Development Companies came to us coming out of the Great Recession, this is under the Obama Administration, and the board said that there are two critical challenges, amongst others, in the 504 program in terms of being able to do economic development.

The first was affiliation. The second was the personal resource test. During the Obama Administration in 2004, we removed the personal resource test with respect to affiliation. We did not ultimately go forward with the affiliation change.

The reason that affiliation has historically been complicated for lender and borrower alike is that the concept under the Small Business Act, independently owned and operated, was viewed as two separate prongs, so independently owned and independently operated.

And what we have chosen to do is interpret the regulation as a non-severable clause, comparable to cruel and unusual punishment, because based on feedback from practitioners, lenders and borrowers, when you ask a small business owner who owns the business, the ownership test is key, and what we found is that the primary driver of size in our programs is determined by the Government contracting and business development size standards, which set based on the industry standard, either revenue or employee threshold.

And under that, even counting affiliates, 97 plus percent of applicants are considered small, and that is by design. That is how the Government contracting, and the lending programs in particular.

In 2010, under the Obama Administration, we passed the law, the Small Business Jobs Act, and that included an alternative size standard which allowed for a $15.5 million tangible net worth and $5 million income test. So, under the lending programs, the size standard has always enabled folks to qualify.

What was confusing was the subjectivity of the concept of negative control on how a lender, without lawyers, could review management agreements that were entered into by third parties.

And so, beyond the size standards, in practice, how this happens is the biggest inhibitor to large entities getting SBA debt is because any owner of 20 percent or more has to provide a personal, unconditional guarantee, and for medium sized entities or publicly traded companies, that is a do not pass go.

And so that critical requirement, together with the fact that a credit not available elsewhere borrower, so somebody that is—can't find conventional credit, can seek today in the junk bond market a 9.3 percent total cost of borrowing versus the current rate for an SBA 7(a) or 504 all in fees plus interest rate, is closer to 11 percent.

Senator SHAHEEN. I have some follow up questions on that that I would like to get explain, but I will do those for the record because I am almost out of time, and I have another question that I am very concerned about. Last August, we talked about staffing levels at district offices.

And your—I think your response to my concern was that it was dependent on the Appropriations committee. Well, I sit on the Appropriations committee, and I want to be clear that I believe the committee thinks that SBA should focus on oversight of lending.

And the SBA now appears to be able to shift resources to add staff in order to do that. But while it is doing that, it is also cutting district offices and small business development centers.

So can you explain the tradeoff there and how we can make sure that our district offices and the small business development centers have the resources they need in order to operate, because they are the ones who really have boots on the ground in our States, who are working with small businesses.

Mr. KELLEY. I apologize. I am the Associate Administrator of the Office of Capital Access, and there is a lot of ground that I cover with the loan programs, the CARES Act programs.

I am not the CFO of the SBA, and I am not the Chief of Staff. I am not the Administrator, and I don't make the budget determinations for the Office of Entrepreneurial Development or the Office of Field Operations.

I also share with you that the district offices, as does the Administrator, are a valuable resource to assisting lenders and assisting borrowers, finding lenders, and we work through those 68 district offices. But I don't really——

Senator SHAHEEN. So last year when you told me that that was dependent on Appropriations, you didn't have the same issues that you do this year?

Mr. KELLEY. Well, it doesn't—doesn't my answer still hold? So, what I am saying is—what I meant by that is if you—if the appropriators disagree with the President's budget, my understanding is that they can appropriate money and in different buckets, in salary and expenses.

And so, all I am trying to say there is that I don't have the ability to move money around at the agency. And I don't have—obviously, I am not a member of, I don't have the ability to appropriate. So that is what I meant by that.

Senator SHAHEEN. Well, thank you for that clarification. I can assure you that I will be advocating that we adequately fund district offices and small business development centers.

And I hope you will take the message back to the leadership at the SBA that this is a priority for the members of this committee and I believe for most of the members of Congress, because they are the folks who actually are working at, they are working with small businesses.

And while we appreciate the support structure that the office gives to those offices, I don't think it ought to be a tradeoff that that we should take the operating expenses away from them so that work can be done in Washington. So, thank you, Mr. Chairman.

The CHAIRMAN. Well, Senator Shaheen knows I strongly support the point that she is making. I think this whole committee does service in the community, and our States are the bedrock of the link between small businesses and the services that we can help provide.

Mr. Shoemaker, the fact that no one asked too many tough questions of you, you should take that as a compliment. Just want you to know that I do hope, though, that there will be a working relationship between SBA and the IG in implementing any expansion of supervision over lenders.

There is a concern about the resources, and I would hope that the Inspector General would work with the SBA to make sure there is adequate personnel to handle whatever responsibilities, whether it is under this new rule or legislative legislation that we pass in Congress.

So, I heard you make that offer of help during your testimony. Just want you to know that we are going to be requesting that you keep us informed as to your observations.

And Mr. Kelley, I have asked this question before of the SBA, and I always get a positive answer that you always want to work with the IG and you are willing to accept their recommendations and try to work in a cooperative spirit and let the record show you are shaking your head affirmatively. And then lastly, let me just point out, that on mission lending, the CA program has mission lenders.

Now, I have confidence in mission lenders, I do, but we have a 60 percent requirement in there and it has worked. The CA program has a record of exceeding twice as many loans in minority small businesses than the CA—than the 7(a) program. So, they are reaching these groups that we cannot specify because of legal challenges.

So, my concern is whether the rule itself will preserve mission lenders. And without being specific, I see the larger loans and the larger lenders may be consuming the mission lenders because they don't have the same type of volume and profit that the larger lenders have.

That is my concern, that they could be consumed without protection built into the program.

Mr. KELLEY. Yes, so I think it is totally—I share and as does the Administrator, and it is a totally legitimate concern that we all care about producing a better set of outcomes than historically we have.

And what I want to underscore is, as Administrator Guzman indicated to you, we intend to preserve the 60, 40 percent threshold in the SOP. Your bill called for 70, 30, as we have indicated to staff in conversations that we have had—as she did.

That might be the right threshold. There are other elements of your bill, for example, with respect to cost that made total sense. And we are putting into the SOP as well. So today the loan loss reserve requirement in the Community Advantage program is 10 percent.

We are putting 5 percent. And I do want to clarify something. There was a lot of comment, public comments in the rulemaking about requiring capital requirements for CA SBLCs and requiring fidelity insurance for SBLCs. That was part of the 100 comments that you are talking about. That was not in the proposed rule.

We did reflect in the final rule the authority for the Administrator, that the person that holds my office or a designee, the right to set those thresholds, as we do in the for profit SBLCs.

And the reason that we created a separate class was to build off of the 13-year pilot where we provided a temporary license, which part of what we waived was the moratorium in that program.

And those lenders can't afford, quite frankly, the liquidity to meet the $5 million threshold that the for profit SBLCs are require for capital, as you know, and the fidelity insurance, which is $2 million and then goes up from there.

The CHAIRMAN. So, lastly, let me mention the affiliation rule and my concern.

Mr. KELLEY. Sure.

The CHAIRMAN. And that is, with the determination of affiliation now being primarily made by the borrower and the lender, rather than the SBA, my concern is that you are liable to see large entities through the use of affiliations that they really control.

They may not have the ownership technically because they can do that through a lot of different mechanisms and policing financial mechanisms with the right to foreclose.

My concern is that are we now going to be seeing more of the resources at SBA going to the larger small businesses rather than the smaller or small businesses, and maybe to businesses that are well beyond the size limitations through the use of affiliation?

It is an issue that has me greatly concerned because I know that you always had the ability to audit, but I don't see, as we have seen before, it is not easy to catch this after the sources are out.

Mr. KELLEY. So, totally, totally agree. Historically, eligibility has been a borrower certification on the form 1919. There is a question regarding affiliate—affiliation, for example.

There are subsequent questions to that. And then the lender was required in all but the franchise area to be responsible for determining whether eligibility had been met. And as is indicated, there have been instances over however many years there have been audit reports that there have been lenders who have approved ineligible loans.

And those ineligible loans are, if they default, if they default in less than 18 months, they are referred to the Inspector General. If they default beyond that, right, we have the ability to repair the guarantee, lower the guarantee, or outright deny it based on the error.

The only instance where eligibility was determined prior to—from 2018 to 2023, a franchise business model could prevent—could present the franchise or agreement, and an attorney at the SBA would review that franchise or agreement for two reasons, affiliation and ineligible business model.

There are 212 instances from 2018 to 2023 where the businesses, the franchisee was disallowed based on ineligible business model.

So, what we are putting in place, and this is what I opened with, and I apologize for starting with CARES Act, but what we were able to do beginning in Biden-Harris was put in 19 automated screening filters, which involves NAICS codes, affiliation, business address, those type of——

The CHAIRMAN. But here is the change. The changes—you have changed the standards on affiliation as well as not having a register.

And when you change the ownership and control issues, it makes it easier for a large company through very sophisticated agreement to control a franchise but still be able to claim that they are independent for the SBA loan.

That is my concern, and I don't think you are going to be able to pick it up under the way you are doing. Let me recognize Senator Ernst for any comments she wants to make, or questions.

Senator ERNST. Yes. Thank you, Mr. Chair. And I do agree we have seen troubles with the affiliation rules in the last couple of years, so I would rather not revisit that.

As we move forward, we need to make sure we are getting it right. So, yes, I don't want you to leave Mr. Shoemaker, or Shoemaker, without feeling you have gotten a fair shot at discussion today.

So just very briefly, I am still having a little bit of trouble wrapping my mind around the $3 million investment for recovering the $71 billion in EIDL.

Mr. KELLEY. To only collect $3 million, to lose $3 million. That is what we are explaining——

Senator ERNST. But there is $71 billion hanging out there of EIDL.

Mr. KELLEY. The $71 billion is the amount of outstanding debt yet to be repaid in the COVID EIDL program. It hasn't defaulted yet. And then in order to get to Treasury offset, we have to—we have offered in compromise as far part of the repayment period where we can create partial payment plans to offset the loss to the taxpayer.

So, it is—we can estimate that every single COVID EIDL loan outstanding under $100,000 is going to default. But we have subsidy models where we forecasted, beginning under the Trump Administration, what the likelihood of default was, and it is based on historic norms.

And so, in the disaster loan program, we normally see 21 percent or higher. In the case of 9/11, it was upward—it was north of 30 percent, with respect to nationwide for default.

Senator ERNST. Okay. So, you—and you are saying here today you will not be seeking loan forgiveness as SBA for EIDL loans under $100,000.

Mr. KELLEY. There is no loan forgiveness allowed in the COVID EIDL program.

Senator ERNST. Nor in the PPP?

Mr. KELLEY. Correct. In PPP, the loan was by design, by statute, it was a forgivable loan. In the COVID EIDL loan program, there was never an option for forgiveness. So, what I am saying is every single borrower has to repay both the PPP loan or seek forgiveness. That is another option they have in PPP.

In COVID EIDL, they only have the option to repay. If they do not repay, right, normally, in the normal disaster loan and in our core programs, we would have personal guarantees, we would have collateral, we would have all these other additional guardrails for collection, which is why we run a negative subsidy, which means we make money for the taxpayer.

In this program, we don't have that. And then when you look at the wage garnishment results, so we can look at the Treasury money that has come back to us over the years for loans where we actually underwrote the loan, right, in the beginning and had these guardrails, and we see we only collected $65,000.

That is why we are making the decision. We are not making the decision to forego offset because we don't want to collect—we would collect—there is no reason why we don't want to collect the money.

We were looking at the cost, benefit and saying, why should we lose $3 million more dollars of taxpayer money?

Mr. SHOEMAKER. If I may——

Senator ERNST. Yes. And I was going to redirect to you. We got into a conversation there, so. Yes, Mr. Shoemaker.

Mr. SHOEMAKER [continuing]. Senator Cardin, we do have a healthy relationship inside of SBA between SBA and OIG, which means that there are areas of disagreement, and this is one. To that extent, we disagree that there was a comprehensive cost benefit analysis performed relative to the PPP.

We have ongoing work in EIDL. And as you appropriately indicated, the area of risk is $71 billion. That area was actually $76.9 billion. My colleague just indicated, you know, that this is just a potential risk. The loans are performing.

Right now, we are seeing more than $60 billion that are past due of that $76.9 billion. And we have seen close to $30 billion that have already defaulted. What that means is that that collections will not go forward through the Treasury offset program.

Collections, you know, can always happen. SBA—and Patrick is absolutely right. You know, first of all, the borrowers should repay. And you know that is first and foremost. And there are other avenues and mechanisms to ensure that they don't gain access to other benefits.

There is reporting as an indication and there is lots of different vectors that get into do not pay. One of them is the Treasury offset program. But what is important about the Treasury offset program, you know, unlike the conversation here is, Treasury offset is a means of collection.

That is how you get the money back that has defaulted. You know, there are—the cost benefit analysis could show other models outside of the Treasury offset program. But our contention is that we believe that a comprehensive cost benefit analysis needs to be performed.

There is an open recommendation on the PPP program. I expect it will probably be revisiting the same conversation when we issue the EIDL report.

Senator ERNST. And I do understand, Mr. Shoemaker, that there is an IG report that is coming out very soon on EIDL collections. Is that correct?

Mr. SHOEMAKER. That is correct.

Senator ERNST. Okay. So, all of that will be spelled out, I assume, in that report.

But I think this dialog today is just all the more reason that with these rules, we need to make sure that things are right. Because if we are seeing fraud in a hastily put together program such as EIDL during COVID, you know, we certainly can expect to see that through fintechs as well and some of the other methods that are coming out through the rules.

We need to protect the taxpayers against fraud. We want to make sure that the dollars are going to those small business entities that are truly deserving and need those resources.

Mr. SHOEMAKER. Right. The answer on the fintechs is, it requires—the lenders require strong oversight and monitoring by the SBA. The SBA is the supervised lender. PPP is completely different that than 7(a) program.

You know, there is the 100 percent guarantee. You are dealing with self-certification. But one of the things that happened, you know, in the use of fintechs as financial technology companies is not—you know, it is a little bit of a misnomer in this idea of fintechs as just—as a lender.

The regulated entity, the supervised entity by, you know, of SBA basically had contractual agreements that exported some of these lending responsibilities, the loans—you know, lending service provider. The lending service providers are under the oversight of the regulated entity. That regulated entity is under the purview of SBA.

So strong oversight and monitoring within the lending community is key to this notion of financial technology companies, you know, being part of the program. Financial technology has been a part of, you know, the banking industry for a long time.

You know, anytime that anybody logs on and does mobile banking, it is probably not the bank that is promulgating that technology. It is probably a contractual relationship.

However, you know, in this model where we are talking about, you know, a relationship where an eligibility decision or know your customer, bank secrecy regulations, I mean, even questions about bank secrecy regulations on whether, you know, some of the loan companies may be even covered by it, I think that needs to be explicit in that regard.

Because the know your customer was what was on the front end of that financial technology. This is where you see, you know, a fraudster hitting 35, 40, hundreds of, you know, loan portals to, you know, steal from the taxpayer.

Mr. KELLEY. Yes, I totally agree. And if you look at—so first, I worked for a bank prior——

The CHAIRMAN. We are going to need to wrap up.

Mr. KELLEY. Okay.

Senator ERNST. Yes. I apologize. Thank you.

The CHAIRMAN. No, sorry. We have two witnesses that have been extremely patient, and this is not the end of our discussion.

I really do appreciate both of your testimony today has been extremely helpful, and I mean that. As I said in the beginning, I want to work in a constructive environment. I still feel the best ways for Congress to speak to policy.

And we have been somewhat missing in action on this issue, so I hope that we will have a chance to express ourselves and we can get something that we are all in agreement with Democrats, Republicans, House, Senate, and the White House. That will give you greater guidance.

And I know the frustration of some of the members and regards to targeted groups. It frustrates me as well, but we have to work within the legal confines to try to achieve these objectives. With that, let me thank both of our witnesses and we will call up the second panel who has been very, very patient.

By the way, there is a vote going on. I have already cast my vote. Senator Ernst has not had a chance to cast that vote yet. So, every once in a while, we have to balance also the votes on the floor of the Senate. Let me welcome our two witnesses.

First, Mrs. Hilda Kennedy. She is the Founder, President of Impact Business Capital, which is a nonprofit certified lender of SBA that participates in the SBA Community Advantage pilot program.

Prior to founding AmPac Capital, Mrs. Kennedy worked in local Government in California. She has also served on the White House and SBA Council on Underserved Communities, and currently serves as the President elect for the National Association of Women Business Owners California.

Ms. Kennedy received her degree from the University of California at Berkeley, completed a postgraduate fellowship with the Corow Foundation, and completed a master's coursework at the University of San Francisco.

Our second witness is Mr. Chris Pilkerton, serves as the Chief Legal Officer for Accion Opportunity Fund, which is the nation's largest CDFI concentrating on small business support for underserved communities.

Prior to his current role, he served as Senior Policy Advisor at the White House, and Executive Director of the White House Opportunity Now Initiative, as well as Acting Administrator and General Counsel of the SBA during the Trump Administration.

He holds a BA from Fairfield University, an MBA from Columbia University, a J.D. from Catholic University School of Law. We will start with Ms. Kennedy.

By the way, your statements all will be made part of the record, without objection. You may proceed as you wish.

STATEMENT OF HILDA KENNEDY, FOUNDER/PRESIDENT, AMPAC BUSINESS CAPITAL, ONTARIO, CALIFORNIA

Ms. KENNEDY. Thank you very much. Chairman Cardin and Ranking Member Ernst in her absence right now, distinguished members of the committee in their absence, good afternoon and thank you for having us today.

As President and Founder of AmPac Tri-State CDC in Ontario, California, as stated, we are an economic development and mission driven lender, and we participate in the SBA 504 Community Advantage and microloan programs, as well as a CDFI.

In fact, as a 504 lender, we have done a little over $1 billion in SBA 504 lending in the past 16 years, and we have on balance sheet a little over $9.8 million in loans through our community impact loan programs from $5,000 to $350,000.

And so, we care deeply about expanding access to SBA lending programs, and my faith is at the root of that. Knowing that with God all things are possible, we approach our work from an it is possible mentality, creating possibilities for the communities who need it most through entrepreneurship, small business formation, job creation, and building generational wealth.

And that is why I believe so strongly that Congress and SBA must address the inequities for underserved businesses and must work in concert and complement each other, and that is my most urgent message today. Looking at the tenets outlined in the small business that it states, and I quote, “that the opportunity for full participation in our free enterprise is essential if we are to obtain social and economic equality and improve the functioning of our national economy.”

So on this 70th anniversary of the Small Business Act of 1953, I believe the Community Advantage Loan Program Permanency Act of 2022, helmed by you Chairman Cardin, and its companion House bill, championed by my Congresswoman Judy Chu, and the SBA’s expected May 12th launch of the final rule with the Community Advantage Small Business Lending License, and the other SBLC licenses, are parallel efforts that can provide the traction to finally hit the stride we have been seeking to elevate our nation.

Chairman Cardin and Representative Chu have been seeking to diligently codify the CA program, and I thank you for your dedication to these communities that are often overlooked. Equally, I think Ranking Member Ernst, whose leadership and commitment to increasing access for rural small businesses, with the mission of the CA program.

Just an example of one of our CA borrowers, Dr. Zuniga and Dr. Espinosa, they were five-year doctors. They had been practicing under a physician, and they wanted to buy their building, or they wanted to do a small business loan to start their practice, but they couldn’t with their bank that they thought they had a relationship with.

So, they came to us. They were turned down because they a startup. They had a lot of student loans, and they had recently purchased their home. But because of our work as a Community Advantage lender, we were able to give them a loan because of the transformational work of the community advantage reforms that happened back in March.

And that really made a difference and I believe was the first and necessary step for the rulemaking process in considering this CA, SBLC, and other SBLC licenses. You will have more details in my written remarks, but I want to close by highlighting my recommendations in my remarks.

First, I believe we need to shift the narrative from either, or to welcoming all efforts to improve access to SBA’s lending programs for underserved communities, which was intended in the Small Business Act.

Second, Congress should pass your bill, Chairman Cardin, and the House bill to make Community Advantage a permanent offering of SBA. Third, Congress should capitalize on challenges faced by mission-based lenders in accessing capital to provide to underserved communities.

And finally, SBA should apply provisions from Chairman Cardin’s bill in areas where the SBA, SBLC, and SBLC rules lack clarity, such as target market cap, capital requirements, loan loss, reserve requirements. Lenders need a bright line and metrics so that we can collectively know what success looks like.

AmPac and the mission lending community will continue helping businesses access capital through the SBA’s lending programs, and we look forward to working with the committee and SBA to create more opportunities for underserved businesses. Thank you.

[The prepared statement of Ms. Kennedy follows:]

Oversight of the SBA's Implementation of Final Rules to Expand Access to Capital

Testimony before the

U.S. Senate

Committee on Small Business and Entrepreneurship

April 26, 2023

Submitted by:

Hilda Kennedy

Founder/President

AmPac Tri-State CDC, Inc., dba AmPac Business Capital

Ontario, CA

Hilda Kennedy
Founder/President
AmPac Tri-State CDC, Inc., dba AmPac Business Capital

Chairman Cardin, Ranking Member Ernst, and distinguished members of the Committee, good afternoon and thank you for having me today. My name is Hilda Kennedy, and I am the President and Founder of AmPac Tri-State CDC in Ontario, California. I am a former board member of the National Association of Development Companies (NADCO), a member of the Mission Lenders Working Group (MLWG), the African American Alliance (AAA) of Community Development Financial Institutions (CDFI's) and the Opportunity Finance Network (OFN).

I appreciate the opportunity to share my perspective on current efforts by Congress, the SBA, and industry participants to improve lending in the communities that struggle the most to access capital to start, sustain, and grow small businesses. As an economic development driven 504 Loan Program lender, an enthusiast participant in the SBA's 7(a) Community Advantage Loan Pilot Program, and an SBA Micro Lender, as well as a CDFI, I care deeply about expanding access to capital through the SBA's lending programs. I strongly believe efforts by Congress and SBA to address inequities for socially and economically disadvantaged businesses can work in concert and complement each other, which is my most urgent message today. Collectively we have strived for decades to fulfill the mission set out with the creation of the Small Business Administration. I believe the ***Community Advantage Loan Program Permanency Act of 2022*** (S. 5102/H.R. 9311), helmed by Chairman Cardin, and its companion House bill championed by my Congresswoman Judy Chu, and the SBA's launch of a Community Advantage Small Business Lending Company (CA SBLC) license are parallel efforts that can provide the traction to finally hit the stride we have been seeking to elevate our nation on this 70th Anniversary of the Small Business Act of 1953 (P.L. 83-163).

I will use the tenets described in the Small Business Act as a guide for my testimony. Section 2 of the Act outlines the findings of Congress and reasoning for creating the SBA. In Section 2(A), the Act states, *"(ii) that certain groups in the United States own and control little productive capital because they have limited opportunities for small business ownership; (iii) that the broadening of small business ownership among groups that presently own and control little productive capital is essential to provide for the well-being of this Nation by promoting their increased participation in the free enterprise system of the United States,*"[1] followed by, "*(B) It is therefore the purpose of the programs authorized by section 7(j) of this Act to— (i) foster business ownership and development by individuals in groups that own and control little productive capital; and (ii) promote the competitive viability of such firms in the marketplace by creating a small business and capital ownership development program to provide such available financial, technical, and management assistance as may be necessary. (iv) that such development of business ownership among groups that presently own and control little productive capital will be greatly facilitated through the creation of a small business ownership development program, which shall provide services, including, but not limited to, financial, management, and technical assistance.*"[2]

These citations outline the importance Congress placed on the role of small business ownership to the national economy, while acknowledging that there are significant gaps to reaching those potential business owners who do not have access to the necessary capital to

[1] Small Business Act, page 2
[2] Small Business Act, page 3

participate meaningfully in the U.S. free enterprise system. The Act further acknowledges the particular barriers that exist for socially and economically disadvantaged businesses and the importance of full participation of these groups in Section 2(B)(f), "*(A) that the opportunity for full participation in our free enterprise system by socially and economically disadvantaged persons is essential if we are to obtain social and economic equality for such persons and improve the functioning of our national economy*,"[3] and, "*(E) that such conditions can be improved by providing the maximum practicable opportunity for the development of small business concerns owned by members of socially economically disadvantaged groups*."[4]

These tenets provide a solid foundation for the important discussion the Committee is having today. Since the formation of the SBA in 1953, it has evolved through the creation of new programs by Congress and development of numerous pilot programs by the Agency, all with the goal of meeting the objectives Congress outlined in the Small Business Act. Today, Congress, SBA, and industry participants are still seeking to meet these objectives and to address the barriers that still exist for small businesses. Different approaches have been taken over the years, but we all share the common goal of increasing access to capital to strengthen local communities, build generational wealth, and support the national economy. While significant improvements have been made, socially and economically disadvantaged entrepreneurs, and small businesses with fewer than 20 employees in particular, continue to face barriers accessing the capital they need to succeed. [5] As such, it is for the "well-being of the Nation," as the Small Business Act intended, that Congress, SBA, and industry participants make meaningful changes to significantly improve opportunities for underserved small businesses to access SBA's lending programs.

SBA has worked for years to reach socially and economically disadvantaged businesses, and in 2011, launched the 7(a) Community Advantage Loan Pilot Program with the goal of expanding SBA-backed lending in underserved markets by allowing experienced, mission driven, nonbank lenders to participate in the SBA's 7(a) loan guarantee program. CA lenders, like AmPac, have demonstrated that Microloan Intermediaries, CDCs and CDFIs have the experience needed to reach, finance and support underserved and undercapitalized businesses. Mission lenders are not simply focused on making loans and sending business borrowers on their way, but strive to improve the outcomes of their borrowers through technical assistance and other business services so the loan is a launching point for growing a successful business, supporting employees, creating jobs, and building generational wealth for entrepreneurs.

Since the first CA loan was approved in 2012, more than 7,673 loans totaling $1,050,734,400 have been made to small businesses in markets that historically have been socially and economically disadvantaged[6]. In fact, according to data from SBA Weekly Lending Reports from 2018 -2022,[7] 13 percent of the loans made by CA lenders went to Black-owned businesses and 15 percent went to Hispanic-owned businesses. During this same time period, 4 percent of the loans made by traditional 7(a) lenders went to Black-owned businesses and 8 percent to Hispanic-owned businesses. Similar, though not as dramatic, results were true for women, veterans and start-

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[3] Small Business Act, page 3
[4] Small Business Act, page 3
[5] Federal Reserve Bank of New York: Double Jeopardy: COVID–19's Concentrated Health and Wealth Effects in Black Communities and Federal Reserve Banks: Small Business Credit Survey: 2021 REPORT ON EMPLOYER FIRMS

[6] Small Business Administration: FOIA - 7(a)(FY2010-FY2019) as of 230331
[7] Small Business Administration: Weekly Approvals Report with data as of 09/30 for each FY 2018- FY 2022

up businesses. Since the CA pilot was launched in 2011, the SBA has issued several short-term extensions of the pilot, including the most recent two-year extension announced in April 2022 that introduced a series of CA program reforms that I will discuss in greater detail later in my testimony.

Most recently, SBA released a final rule, ***Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization***, which will be effective on May 12, 2023 and amongst other things, is an effort to increase lending in underserved communities.[8] According to the rule, the SBA "***has determined that certain markets** where there are capital market gaps continue to struggle to obtain financing on non-predatory terms. Therefore, SBA is lifting the moratorium on licensing new Small Business Lending Companies (SBLC) and creating a new type of SBLC to help bridge this financing gap*."[9] The SBA's creation of a new type of SBLC, a Community Advantage SBLC, is intended to provide a permanent avenue for small dollar lending in socially and economically disadvantaged communities, and create certainty for current and prospective lenders. Current CA lenders will be grandfathered into the Community Advantage SBLC, and new lenders would be directed to apply to the Community Advantage SBLC program since the SBA will not be extending the September 30, 2024 expiration date for the Community Advantage Pilot Program.[10] Additionally, SBA will determine on a lender-by-lender basis the maximum loan size, target market, geography, capital requirements, fees and other programmatic requirements for participation.

While SBA proposed this rule as a solution to meet the needs of more underserved borrowers, Congress has also been hard at work to address the needs of socially and economically disadvantaged businesses. Last November, as noted earlier, Senate Small Business and Entrepreneurship Committee Chairman Ben Cardin and my Representative Judy Chu (CA-28) introduced the ***Community Advantage Loan Program Permanency Act of 2022***, which would make the CA program permanent with needed adjustments to expand access.[11] I, along with all of the organizations I am part of, supported this important 2022 legislation as the path to the permanency for the Community Advantage Loan Program. Chairman Cardin and Representative Chu have worked diligently for years to codify the CA program and I want to express my thanks for their focus and dedication to the communities that are left behind, and often overlooked. I also want to applaud Ranking Member Ernst, whose fresh leadership and commitment to increasing access to capital for rural small businesses is aligned with the mission of the CA program to reach such businesses and create healthy local communities.

As an industry participant in multiple SBA programs, as well as a CDFI through the Treasury Department, I would like to speak to the work my CDC and CDFI undertakes to reach businesses who desperately need access to capital, and in some cases technical assistance, and our ability to provide this support through SBA's lending programs. While I am not alone in my focus on socially and economically disadvantaged businesses, each CDC reaches communities in different ways and through different programs, so I will focus on AmPac and our daily work. First and foremost, the founding of AmPac Tri-State CDC is rooted in my faith. We approach our work from an "It Is Possible" mentality, knowing that with God, All Things are Possible. We believe

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[8] Federal Register :: Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization
[9] Federal Register :: Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement for a Loan Authorization
[10] Ibid.
[11] Cardin Introduces Legislation to Codify SBA's Community Advantage Pilot Program - Press Releases - U.S. Committee on Small Business & Entrepreneurship (senate.gov)

we have been divinely appointed to create "possibilities" for the communities who need it most through entrepreneurship, small business formation, job creation, and building generational wealth. It is so impactful to see the zeal and hard work of the borrowers I work with when they are given an opportunity to see what is "possible" after being faced with so many closed doors.

AmPac has created "A Success Capital" micro loan product that provides Black and Brown small businesses with a micro loan up to $50,000 using alternative underwriting guidelines, and supporting them with training and coaching, or "wrap around services," to support their success. For businesses that attend three documented business trainings per year and make timely monthly payments, we reduce their interest rate by half a point for the first three years and provide them either a training grant or reduction in the principal of their loan. The Latina led bookkeeping firm who has received this loan, after being denied multiple times by other lenders, has already reduced her loan's principal by $2,000 and her interest rate by 1 percent.

After assessing barriers to entry to the 504 Loan Program for socially and economically disadvantaged businesses, we surmised that the reason these businesses were not accessing the program was not because they lacked the business acumen to do so, and not because they were not paying rent that could have been replaced with a mortgage, but because they struggled to meet the downpayment requirements. To address this issue, we raised $4 million in investment capital through our CDFI from a social impact investor, Edwards Life Sciences in Orange County, California, who set aside investment funds from their profit to support CDFI's and non-profits doing work to elevate wealth and economic parity for Black and brown communities. We have used these funds to provide down payment assistance or liquidity replacement for these targeted businesses to buy their building with the SBA 504 Loan Program. In 2022, we used almost $1 million of the investment to leverage over $39 million in commercial real estate loans to Black and Brown businesses, who otherwise would not have been able to purchase their building. One Black led business owner who grew up in poverty in the Bronx and runs an auto auction company in Riverside, California, said that his greatest aspiration was to buy his mother a home of her own. He used lessons learned from helping his mom to buy the building for his business. The down payment assistance program and the SBA 504 Loan Program made IT POSSSIBLE.

In addition to our efforts utilizing the 504 Loan Program, the Community Advantage Loan Program has been game changing for us to serve small businesses and create more opportunities for socially and economically disadvantaged businesses. I want to take time to acknowledge the SBA Administrator, Isabella Guzman, and her team led by Patrick Kelley, who leaned in to hear from lenders in the trenches to discuss much needed reforms to the Community Advantage Loan Program. They spent months seeking to understand the barriers to entry and they executed on what they heard from industry participants. Many of my colleagues who have done this work longer than AmPac, especially in underserved communities, said they were CA lenders in name only until the reforms adopted last year – they have been that impactful. They now have strong pipelines to serve businesses since they can use the prudent credit guidelines that govern their CDFI and other loan programs, and are not hindered by some of the collateral requirements and lending criteria in the original CA guidelines that the businesses in underserved communities simply could not meet.

I would like to share the following example of one of our Community Advantage borrowers. Dr. Zuniga and Dr. Espinosa were referred to AmPac by a large bank who had to turn down their loan. Although they had been medical doctors for five years, they worked for a practice and did not operate a practice on their own. The owner of the practice promised that he would sell them the practice and "carry paper" for them to become the next owner so they would not have to worry about getting a loan. Later they learned the doctor had sold the practice to a large medical conglomerate, which propelled them to start their own medical practice. They went to the bank where they had their personal accounts, but the lender could not help because they were a start-up with no business ownership experience, significant student loan debt, and a recent residential mortgage. They did not meet the traditional 5C's of credit. AmPac stepped in with our business coach to help them create business projections and because of our credit policy, we were able to place a UCC filing on the business and not require additional real estate collateral, which would have been a challenge for the young couple starting a family and a business concurrently. Now these doctors are providing needed medical care in their community.

Finally, I offer the following recommendations as the Committee and the SBA, in partnership with mission driven lenders like AmPac, continue working to ensure that socially and economically disadvantaged businesses can access the capital and support they need to launch, grow, and ultimately become bankable with the help of SBA's lending programs:

- **First, and most importantly, I believe we need to shift the narrative from "either/or" to welcoming all efforts to improve access to SBA's lending programs**. This shift in narrative moves us forward in a decades-long effort to realize the intention of the Small Business Act of 1953, "*that the opportunity for full participation in our free enterprise system by socially and economically disadvantaged persons is essential if we are to obtain social and economic equality for such persons and improve the functioning of our national economy.*"

- **Second, Congress should pass Chairman Cardin's and my representative, Representative Judy Chu's, bill to make the 7(a) Community Advantage Program a permanent offering of SBA's Office of Capitol Access.** After operating as a pilot program for more than 10-years, and demonstrating that experienced mission driven lenders, like AmPac, can effectively increase SBA backed lending to businesses and entrepreneurs in underserved communities – the Community Advantage Loan Program has succeeded in meeting its intent and should be made permanent.

- **Third, Congress should consider the capitalization challenges faced by mission lenders and work toward solutions to mitigate these challenges and enable us to reach more socially and economically underserved businesses.** Unlike conventional bank lenders, mission driven lenders do not have access to capital sources like the Federal Reserve discount window. Thus, we spend a good deal of our time raising money to capitalize our loan funds. Non-profit mission lenders are the right lenders to reach underserved businesses, but as non-profits we face unique constraints that make every additional cost in funds, or in raising funds, translate to a reduction in the number of loans to the borrowers we are so passionate about serving. There is a myriad of ideas to make progress on this issue and those conversations should occur as Congress considers legislation and SBA considers the CA SBLC.

- **Fourth, SBA should apply integral provisions from Chairman Cardin's bill in areas where the CA SBLC final rule lacks clarity for industry participants.** Those provisions include: the definition of underserved community; metrics for success including target market and percentage of loans in that market; capital requirements; and loan loss reserve requirements.[12] Senator Cardin's bill codifies critical metrics to give Community Advantage, and Community Advantage SBLCs, a bright line for who we are targeting, how much of our portfolio needs to hit that target, and what we need to set-aside in terms of capital in order to maintain SBA compliance. Metrics ensure effective management, and mission lenders are committed to doing this work right so that these targeted communities can be elevated, on purpose and with intention. I appreciate SBA's efforts to create a permanent pathway for CA lenders to become Community Advantage SBLCs – this is an innovative approach to make the SBA's 7(a) Loan Program accessible to mission-oriented lenders committed to facilitating economic parity in meeting the capital needs of socially and economically disadvantaged businesses.

AmPac and the mission lending community will continue to provide small businesses with every avenue possible to access capital through the SBA's lending programs and we look forward with anticipation to action of this Committee and at SBA to create more opportunities for socially and economically disadvantaged businesses. I sincerely appreciate the opportunity to testify this afternoon, and I look forward to answering any questions.

[12] Cardin Introduces Legislation to Codify SBA's Community Advantage Pilot Program - Press Releases - U.S. Committee on Small Business & Entrepreneurship (senate.gov)

The CHAIRMAN. Thank you very much for your testimony. Mr. Pilkerton.

STATEMENT OF CHRIS PILKERTON, CHIEF LEGAL OFFICER, ACCION OPPORTUNITY FUND, TILGHMAN, MARYLAND

Mr. PILKERTON. Thank you, Chairman Cardin, and thank you, the Ranking Member, Ernst, for holding this committee meeting today.

I am honored to be with Ms. Kennedy and to receive the invitation to this hearing, because I believe the thoughtful support for small businesses must be a bipartisan priority. Over the last several years, I have spent my career focusing on issues related to the small business community, with a particular focus on underserved populations.

I served as the GC at the U.S. Small Business Administration under Linda McMahon, serving from 2017 to 2020, as well as the Acting Administrator of the agency from April 2019 into early 2020.

During my tenure as Acting Administrator, I was particularly proud of our efforts to lead workforce development programs, for far too often, marginalized citizens, such as those returning from incarceration, young adults aging out of foster care, as well as workforce opportunities for disabled individuals.

In March of 2020, I was asked to join the White House to lead a program called the Opportunity Now Initiative, which included significant outreach to underserved communities on the topics of access to capital and technical assistance through State and local officials, as well as webinars with minority focused trades such as the National Minority Supplier Diversity Council.

Since leaving Government, I have continued this work in various capacities. First and foremost, I serve as the Chief Legal Officer for Accion Opportunity Fund, the leading nonprofit community development financial institution focused on small business lending to communities of color, low income—low to moderate income borrowers all across the country, and women.

I have also co-founded and developed an initiative called the Small Business Corps, a private sector led program to provide underserved small businesses with specific, goal focused technical support provided by fellows who are recent college and business school graduates.

That program is housed at the Georgetown University McDonough School of Business and includes DMV engagement from schools such as Georgetown, Johns Hopkins, Old Dominion, as well as HBCUs, Howard, Morgan State and Norfolk State.

I have also worked closely with the performing artist Ice Cube and his work to identify and secure opportunities for black owned businesses in the corporate supply chain.

Our most recent success was a commitment from the National Football League to provide $150 million in contract opportunities to several black owned businesses, including Fearless, a technology company located in Baltimore, Maryland, that has gone on to incubate other minority and women owned companies in that city.

We all agree that increased access to capital for underserved communities is important, but like anything, there is the goal and the execution of the plan to achieve that goal. I will begin by addressing the rule regarding the lifting of the SBLC moratorium and the creation of the new mission based SBLC category.

While I understand the intention of the rule, it does not speak to the critical need to establish a consistent approach to responsible under review, but rather highlights that the agency needs flexibility in its lender evaluation to address unforeseen circumstances.

While I appreciate the need to be flexible on certain components of such a program, underserved borrowers need that certainty of publicly articulated standards to ensure they are dealing with responsible and vetted lenders.

As SBA Inspector General Hannibal said, for whom I have tremendous respect, in a House hearing last week in response to this issue, he said he has concerns with the inclusion of any lender that doesn't have clear rules, an internal control structure, and a proper oversight mechanism.

In short, appropriate inspection and oversight on the front end can limit investigations, enforcement proceedings, and harm to borrowers on the back end.

As such, I recommend that in consultation with Congress, the implementation of this rule will be delayed until there has been an independent study, a business plan, if you will, about the necessary guidelines and procedures that should be in place in order to secure a safe and responsible lending environment for those businesses and provide clear and consistent rules for those participating lenders that may, in fact, be new to the SBA landscape.

When it comes to lending to underserved communities, we have frameworks to examine, such as the Treasury's CDFI pending certification program rules that are already in place and would serve as valuable data points for consideration.

All this as set forth in the Responsible Business Lending Coalition letter for comment on this rule. I also have concerns with the bandwidth of the agency to oversee the influx of program participants contemplated in this rule.

The SBA career staff are some of the most dedicated public servants I have ever worked with, but with limited resources, they may very well be stretched beyond their capacity. The agency needs to ensure that the staff has the resources they need to implement a program that can sensibly be regulated in a consistent fashion.

I believe a thoughtful, independent analysis could calculate the required resources and provide necessary confidence to the marketplace. As to the rule on affiliation, Senator Cardin, I share your concern. I think it is important that this body consider the potential unintended consequences of removing this standard from SBA's analysis.

The reason the rules are in place is to ensure that taxpayer guarantees are truly going to the statutorily mandated, independently owned and operated small businesses that need this unique Government program, and that it is not a subsidy program for larger corporations who already have a competitive advantage.

The combination of these changes to the program as currently written, coupled with the trusted imprimatur of SBA, could undoubtedly result in a significant flow of capital.

But I believe a thoughtful, independent study around these programs would help ensure the integrity of the admitted lenders, maximize the flow of responsible loans to small businesses, and minimize the potential for fraud.

The results of such an analysis could ensure that Congress, the agency, and the American taxpayer have clarity on how the scope of this program can truly support our country's underserved communities in a way that is both responsive and responsible. Thank you very much.

[The prepared statement of Mr. Pilkerton follows:]

Senate Small Business Committee Hearing- "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital," April 26, 2023

Testimony of Chris Pilkerton, Chief Legal Officer at Accion Opportunity Fund

Thank you, Chairman Cardin, Ranking Member Ernst, and all of the committee members. I am honored to receive the invitation to this hearing, as I believe that thoughtful support for small businesses must be a bipartisan priority.

Over the last several years I have spent my career focusing on issues related to the small business community- with a particular focus on underserved populations. I served as the general counsel of the U.S. Small Business Administration under Administrator Linda McMahon, serving from 2017-2020, as well as the Acting Administrator of the agency from April 2019 into early 2020. During my tenure as Acting Administrator, I was particularly proud of our efforts to lead workforce development programs for too often marginalized citizens- such as those returning from incarceration, young adults aging out of foster care, as well as workforce opportunities for disabled individuals. In March of 2020, I was asked to join the White House to lead a program called the Opportunity Now initiative, which included significant outreach to underserved communities on the topics of access to capital and technical assistance through state and local officials, as well as webinars with minority- focused trade organizations such as the National Minority Supplier Diversity Council.

Since leaving government, I have continued this work in various capacities. First and foremost, I serve as the Chief Legal Officer for Accion Opportunity Fund, the leading nonprofit community development financial institution focused on small business lending to communities of color and low-to-moderate income borrowers all across the country. I have also co-founded and developed an initiative called the Small Business Corps - a private- sector led program to provide underserved small businesses with specific goal-focused technical support provided by fellows who are recent college and business school graduates. That program is housed at the Georgetown University McDonough School of Business and includes D-M-V engagement from schools such as Georgetown, Johns Hopkins, Old Dominion, as well as HBCUs Howard, Morgan State and Norfolk State. I have also worked closely with the performing artist Ice Cube in his work to identify and secure opportunities for Black-owned businesses in the corporate supply chain. Our most recent success was a commitment from the National Football League to provide $150 million in contract opportunities to several Black-owned businesses, including Fearless- a technology company located in Baltimore, Maryland that has gone on to incubate other minority and women-owned companies in that city.

We all agree that increased access to capital for underserved communities is important, but like anything, there is the goal and the execution of the plan to achieve that goal. I will begin with addressing the rule regarding the lifting of the SBLC moratorium and creation of the new Mission Based SBLC category. While I understand the intention of the rule, it does not speak to the critical need to establish a consistent approach to responsible lender review, but rather highlights that the agency needs flexibility in its lender evaluation to address unforeseen circumstances. While I appreciate the need to be flexible on certain components of such a program, underserved borrowers need the certainty of publicly articulated standards to ensure that they are dealing with responsible and vetted lenders. As SBA Inspector General Hannibal Ware, for whom I have tremendous respect, said in a House hearing last week in response to this issue, he has concerns with the

Senate Small Business Committee Hearing- "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital," April 26, 2023

Testimony of Chris Pilkerton, Chief Legal Officer at Accion Opportunity Fund

inclusion of any lender that doesn't have clear rules, internal control structures and a proper oversight mechanism in place. In short, appropriate inspection and oversight on the front end can limit investigations, enforcement proceedings and harm to borrowers on the back end.

As such, I recommend that in consultation with Congress, the implementation of this rule be delayed until there has been an independent study about the necessary guidelines and procedures that should be in place in order to secure a safe and responsible lending environment for these small businesses and provide clear and consistent rules to participating lenders that may in fact be new to the SBA landscape. In fact, in Inspector General Ware's testimony, he indicated that his office has a forthcoming report outlining what the proper control environment should look like. Further, when it comes to lending to underserved communities, other responsible lending frameworks, such as Treasury's CDFI certification program, are already in place and could certainly be valuable data points for consideration.

I also have concerns about the bandwidth of the agency to oversee the influx of program participants contemplated by the rule. The SBA career staff are some of the most dedicated public servants I have ever worked with, but with limited resources, they may very well be stretched beyond their capacity. The agency needs to ensure that the staff has the resources they need to implement a program that can be sensibly and consistently regulated. I believe a thoughtful independent analysis could calculate the required resources and provide necessary confidence to the marketplace.

As to the rule on affiliation, I think it is important that this body consider the potential unintended consequences of removing this standard from SBA's analysis. The reason that the affiliation rule is in place is to ensure that the taxpayer guarantee is truly going to those statutorily-mandated independently owned and operated small businesses that need this unique government program- and is not a subsidy program for larger corporations - who already have a competitive advantage.

The combination of these changes to the program as currently written – coupled with the trusted imprimatur of the SBA - could undoubtedly result in a significant flow of capital, but I believe a thoughtful, independent study around these program changes would help ensure the integrity of the admitted lenders, maximize the flow of responsible loans to small businesses and minimize the potential for fraud. The results of such an analysis could ensure that Congress, the agency and the American taxpayer have clarity on how the scope of this program can truly support our country's underserved communities in a way that is both responsive and responsible. Thank you.

The CHAIRMAN. Well, let me thank both of you. Mr. Pilkerton, good staff work. You mentioned Fearless. That was a—you got my attention early in your testimony.

To both of you, your testimonies are extremely helpful. And I thank you for your patience because I think your contributions are so valuable.

Ms. Kennedy, I want to agree with you. Look, the Biden Administration extended the CA program and gave it greater life. So, we are very appreciative of what they have done. This rule has the benefit of finding a home for the CA program, which is something that I think is important.

That is why I have introduced legislation that I did. So, I think we are all in the same path here. It is not either or, it is how we get it done right.

So, I appreciate the way that you said that. And Mr. Pilkerton, flexibility versus certainty. You are absolutely right. I can tell you certainty is critically important. If you are going to be in this business, you need to know what the rules are.

You can't say, well, we want this to go right, and we will look at your individual case by case and determine whether we think it meets that standard. That is not the way you can get partners that are your partners. You are not going to enter that field.

So, I agree with the points that both of you have reached. But here is my point. I am trying to make this as distinct as possible. This rule is going into effect and most likely will remain in effect.

I think we have a responsibility to do exactly what the two of you have said, and that is by legislation. And we are going to work very hard to get legislation done.

So, to Mrs. Kennedy, how do we—what additions would you like to see Congress impose to make sure that we are focusing on those who need, the underserved—focusing on the smaller of the small businesses?

What changes would you like to see Congress entertain in order to make that possible? I appreciate your support of my legislation. I think we should make the CA program permanent. It is not inconsistent with the rule.

So, I think we can do that—we can consider that, but what else should we be doing to make sure that we are focused on the goal of helping those who really need the help?

Ms. KENNEDY. Thank you, Senator—Chairman Cardin. I think that you—it is also in the legislation, really codifying standards.

You know, lenders do need a bright line test. We do need to document how do we know we have been successful. So, the elements of loan loss reserve, the elements of the cash required, and then the definition of underserved, especially the definition of underserved.

The fact is Community Advantage today does have a threshold—60 percent of your loan portfolio has to go to underserved communities. And I just believe if you aim at nothing, you will hit it every time.

So, if you don't have guidelines, you are going to hit that. But if you do have guidelines, you are going to hit that. And that is what CA does today, and that is what has to happen going forward.

So, codifying that legislatively is the right way to move that forward because discretion is discretion. And so, in the next Administration, that discretion may look different, but if we have the legislation to back that up, I think it is hugely significant and I appreciate the direction and your commitment to that.

The CHAIRMAN. Thank you. Mr. Pilkerton, let me ask you a question of what would you recommend as we should take up for certainty?

I mean, you mentioned the concern about knowing the rules. What rules are important for Congress to weigh in, to make clear that is not in the proposed rule? And then the second question I would ask deals with the affiliation rules.

There are some good things in the affiliation rule, trying to make it streamlined just a little bit. What do you think—what protections do we need to add to make it clear that we don't want the big corporations being able to come in under this revised rule?

Mr. PILKERTON. So, I will start with what the agency I think should be looking at, as far as making loans in underserved communities. I think that this rule as written is going to have a lot of capital that goes into the system. And I think everybody touched on this.

My biggest concern about these rules is OCRM, right, the Office of Credit Risk Management. They are the cop on the beat. You saw the Inspector General here today. They are the cop after the fact.

So, giving OCRM what they need is really, really critical. And I think that is where an independent study could be incredibly helpful. Let's think about what just happened to the agency.

For the last two years, the SBA became the tip of the spear on almost $1 trillion program. You have 2,000 people or so that work there. Many of them worked there for decades, and they were ready to retire in 2019, into 2020. They didn't. They didn't because they wanted to actually make it through PPP, help their colleagues, and help the American people. But they have retired.

And so, you have got a lot of institutional knowledge, decades, I mean, probably hundreds and hundreds of years of SBA experience that has left because they have, you know, obviously had the right to and it has been good for them to retire. I really think OCRM should be a huge focus of this committee, in part too, because the rule doesn't address a lot of these rules that were put in place.

I had the opportunity to listen to the earlier testimony. I learned stuff about what is going to be happening in these programs. And without putting that information into the notice and comment period, the public doesn't have the opportunity to opine on that.

So, I think that is going to be a critical piece for the agency and for this committee. The second thing I will say about affiliation. I want to give you an example of something that we did in 2018. It was called the Franchise Directory, and Mr. Kelley made reference to it.

Basically, what was happening was these borrowers were doing these eligibility reviews and you were getting inconsistent analysis. The people in my office when I was in the Office of General Counsel ended up putting together a list that got, I believe it was over 4,000 different franchises.

We reviewed all of those agreements, and if the agreements didn't meet the standard that franchises were separate from the franchisors, then they would actually sign an addendum to the agreement to ensure that they were eligible. The thing about franchises is there a huge opportunity for underserved communities.

A number of folks that actually work in a franchise, a really high percentage of those will go on to own a franchise. And the reason it was good policy was because if I wanted to open up a restaurant, for example, as a borrower, I could see there is that sandwich shop I want to open up and I could go into an SBA lender and say, look, it is on the franchise directory, so you have to make me that loan, assuming I meet all the other requirements.

And that lender had the certainty of knowing that if I defaulted on that loan, they would get the SBA guarantee. So, I think it is really important. And the way the rules written now, I am very concerned that there is a bit of a slippery slope, particularly in that space.

The CHAIRMAN. Thank you. Senator Ernst.

Senator ERNST. Yes, thank you. This has been just a great discussion this afternoon. And I thank you both for being here and sharing your thoughts with us. Mr. Pilkerton, you have already answered a number of my questions.

Senator Cardin had asked a number of those as well. So, I will move on to you, Ms. Kennedy. As part of the SBA's defense of the affiliation rule, part of that defense has been the 504 lenders welcome the underwriting and affiliation changes.

It is important for all of us to differentiate between what is a 504 and what is a 7(a) loan program. The 504 loan program is an economic development program with job creation goals, and nearly every 504 loan receives approval from SBA before those funds are disbursed.

So, this rule will create a more of a one size fits all approach to underwriting all of those SBA 7(a) loans and 504 loans. So, can you walk us through the 504 underwriting process, and why these changes might be acceptable for 504 but not for 7(a)?

Ms. KENNEDY. Thank you, Ranking Member Ernst. I want to thank you for this question because it is a really important question and a really critical distinction between the 504 program and the 7(a) program, the 7(a) being more of a general purpose loan program—the 7(a) program, and the 504 being targeted for job creation and economic development through ownership of commercial real estate and equipment.

And that is significantly a difference with the 504 program, in that we are required statutorily to be an economic development and job creation program. And there are five components.

There are several other differences between the programs, but I am going to focus on your question related to underwriting. There are five components of the underwriting program for 504 in this public private, partnership.

So, there is a first trust deed lender, and then there is the SBA second. That is where the CDC, or certified development company—both lenders, underwrite the loans. So, the first trusted lender underwrites their portion of the loan.

Typically, up to 50 percent of the loan amount, could be more. And it has to go through their underwriting, and underwriting policies according to their regulations. The SBA 504 portion by the CDC is underwritten by the CDC, and then it goes to an independent loan committee of the CDC that must have at least two commercially licensed bankers on that committee.

And then that loan is sent to the SBA to review for eligibility and credit matters. So you can see it has several different steps in the underwriting process to ensure that it meets all of the eligibility requirements of the program, and so addressing those matters associated with the affiliation, there is no compromise of the loan in terms of eligibility and credit, and in terms of meeting the SBA size standards so that we are really targeting those businesses that are small under the SBA size standards.

Senator ERNST. Yes. Thank you very much. And, Mr. Chair, I will go ahead and yield back the rest of my time. Thank you.

The CHAIRMAN. Once again, let me thank both of you. We are going to be reaching out to you as we are working together. There is going to be a process in regards to this rule, and I think both of you can be extremely helpful to us.

So, I hope that we can have communications beyond this hearing as we try to deal with this, because I think we all have the same objectives. We are all trying to achieve the same thing.

I think Senator Ernst and I want to see more certainty. We want to see more direction. We think it is our responsibility. We are disappointed that the rule didn't provide that.

And we understand the Administration will correct some of that on the SOPs, but it would be better, the more definitive legislations. The best second best is by regulation. So, we are going to try to correct that as we go forward.

We will keep the record of the committee open for seven days for additional questions that may be asked by members of the committee.

I expect that that will be more directed towards the first two witnesses and the second two witnesses, but we would ask that they be promptly responded to that.

And if there is no further business, the committee will stand adjourned, with thanks.

Senator ERNST. Thank you very much.

[Whereupon, at 5:30 p.m., the hearing was adjourned.]

APPENDIX MATERIAL SUBMITTED

NADCO
National Association of Development Companies

April 26, 2023

Honorable Benjamin Cardin
Chairman
Senate Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

Dear Chairman Cardin:

As mission-based lenders focused on economic development in our local communities, certified development companies (CDCs) take seriously our role of getting capital into the hands of small businesses who need it. We undertake this mission through delivery of multiple Small Business Administration (SBA) programs, including the 504 Loan Program, 7(a) Community Advantage Pilot Program, and the Microloan Program.

Over the years, we have supported efforts to broaden the scope of SBA programs to reach more borrowers for whom they are intended – those who struggle to access capital through the private marketplace, and particularly, socially and economically disadvantaged businesses. As such, we have strongly supported legislation to codify the Community Advantage program, which has proven it reaches these businesses through over a decade of lending activity as a pilot program.

We applaud you for introducing the *Community Advantage Loan Program Permanency Act of 2022* last November, which would make the Community Advantage program a permanent offering of the SBA's Office of Capital Access and incorporates lender feedback and best practices. First and foremost, creating certainty for lenders through permanency will address a major barrier to reaching more borrowers by growing the lender base. Furthermore, provisions in the bill to expand the definition of underserved market and provide metrics creating a clear guide for lenders to be successful are integral to extending our reach in an outcomes driven manner.

Thank you for your leadership and effort to codify policies that focus on underserved borrowers and recognize the impact they have in creating strong communities, stabilizing our national economy from the ground up, and building generational wealth. We continue to enthusiastically support your diligent efforts to amplify their impact and create parity in access to capital this Congress.

Sincerely,

Rhonda D Pointon

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

3138 10th Street North
Arlington, VA 22201-2149
703.522.4770 | 800.336.4644
f: 703.524.1082
nafcu@nafcu.org | nafcu.org

National Association of Federally-Insured Credit Unions

April 25, 2023

The Honorable Ben Cardin
Chairman
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable Joni Ernst
Ranking Member
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

Re: Tomorrow's Hearing: "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital"

Dear Chairman Cardin and Ranking Member Ernst:

I write to you today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU) to share our thoughts on issues of importance to credit unions ahead of tomorrow's hearing, "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital." NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 135 million consumers with personal and small business financial service products. We would like to thank you for this opportunity to share our concerns about the Small Business Administration's (SBA) final rules to expand its lending networks.

As champions of financial inclusion, credit unions have been at the forefront of efforts to increase access to personal and small business financial services for underserved communities. Credit unions have grown their overall business lending portfolio by more than 20 percent this past year, which is nearly identical to the growth rate over the past five years. At the same time, NAFCU has worked tirelessly to ensure that non-depository financial institutions such as fintechs operate on a level playing field with credit unions to protect consumers and small businesses. Unfortunately, we are concerned that two recent actions by the SBA may end up running counter to these efforts by opening the programs to unregulated competition.

On April 10th and April 12th, 2023, the SBA published two final rules: (1) Amending regulations governing SBA's 7(a) Loan Program and 504 Loan Program, including regulations on use of proceeds for partial changes of ownership, lending criteria, loan conditions, reconsiderations, and affiliation standards; and (2) Amending its business loan program regulations to lift the moratorium on licensing new Small Business Lending Companies (SBLCs) and add a new type of lending entity called a Community Advantage SBLC, in effect allowing fintech lenders that are only supervised by the SBA's Office of Credit Risk Management to participate in the 7(a) Loan Program. While these are two separate rules, they will have the combined effect of loosening 7(a) lending standards at the same time as opening that program to entities already proven to be more susceptible to fraud than traditional depository institutions overseen by federal prudential regulators. It may be appropriate to reduce 7(a) lending standards for institutions already bound to follow underwriting requirements set by their prudential regulator, but any newly licensed SBLCs will have no such requirements. Fintechs will be participating in an unfamiliar-to-them lending program with few established standards to follow, and subject only to oversight from the SBA that does not include supervision for compliance with Bank Secrecy Act and anti-money laundering requirements, concentration caps, safety and soundness parameters, stress test parameters, and other regulatory criteria to promote prudent lending.

Allowing fintechs to participate in 7(a) lending on those grounds will place credit unions and other traditional lenders at a severe competitive disadvantage. Non-depository SBLC lenders implementing less stringent underwriting requirements, and with significantly less regulatory compliance cost, will expend fewer resources to offer SBA loans and will therefore be able to offer these loans at more favorable terms. Small businesses will likely gravitate toward these riskier lenders, reducing demand for SBA loans from depository institutions and gradually reducing the number of depository institutions participating in SBA lending. With a greater reliance on fintech lenders, SBA lending programs will be at increased risk of fraud, credit losses, and reputational risk. This risk was clearly demonstrated in the early stages of the pandemic when fintechs participating in the Paycheck Protection Program experienced much higher levels of fraud compared to regulated financial institutions.

The bottom line is that credit unions continue to be a safe, secure, and reliable lender that provides access to personal and small business financial services for underserved communities, and these SBA rules will only create more unregulated competition. We oppose allowing fintechs to participate in SBA lending programs without sufficient regulatory oversight. The new Affiliation and SBLC Rules combine to give unregulated fintech lenders an unfair competitive advantage and put consumers, small businesses, and SBA programs themselves at risk of fraud, credit losses, and reputational risk. We urge Congress to use its oversight authority to step in and bring about changes.

We thank you for the opportunity to share our thoughts and look forward to continuing to work with you on improving the SBA's lending programs. Should you have any questions or require any additional information, please contact me or Amber Milenkevich, NAFCU's Senior Associate Director of Legislative Affairs, at (703) 402-2330 or amilenkevich@nafcu.org.

Sincerely,

Brad Thaler

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the U.S. Senate Committee on Small Business and Entrepreneurship

Senator Marco Rubio
U.S. Senate Small Business Committee
"Oversight of SBA's Implementation of Final Rules to Expand Access to Capital"
Statement for the Record
April 26, 2023

Thank you, Chairman Cardin and Ranking Member Ernst, for convening this important hearing.

According to the Federal Reserve's 2022 Small Business Credit Survey, 54 percent of small businesses had financing needs to grow their business but did not apply for a loan in the prior year. These discouraged firms cited weak business financials as a reason their firm would not be approved. The SBA's small business loan programs exist to fill this gap in the small business lending market. As Congress and the SBA work to improve the loan programs, we must follow two necessary principles. SBA loan programs must 1) be deployed efficiently and quickly to meet borrower needs without sacrificing anti-fraud and prudent lending guardrails, and 2) they must minimize programmatic costs and subsidy risks for the taxpayer. I have found that these two recently finalized rules neglect both principles. Once implemented, these rules—which run counter to congressional intent—would result in inadequate oversight of Small Business Lending Companies (SBLCs) and "Community Advantage SBLCs" (CA SBLCs), as well as increased costs and financial risks for the 7(a) Loan Program.

With regard to the "[SBLC] Moratorium Rescission and Removal of the Requirement for a Loan Authorization" rule, the SBA seeks to lift the forty-year long SBLC moratorium and create a new type of SBLC called CA SBLCs in the name of filling capital market gaps. However, there are numerous problems with this rule: 1) it does not state how SBLC and CA SBLC licenses will be evaluated, or rescinded, due to poor performance, excessive losses, fraud, or failing to close market gaps; 2) it exempts CA SBLCs from existing minimum capital requirements that are applicable to existing SBLCs, while giving the agency broad discretion to determine capital requirements on a case-by-case basis; 3) it does not have a requirement for CA SBLCs to continue making small-dollar loans; 4) it does not cap the number of SBLCs that can be licensed by the SBA; 5) it does not ensure that the SBA Office of Credit Risk Management will be able to oversee new, non-regulated lenders, many of which will be non-bank financial technology companies, or "FinTechs;" and 6) it acknowledges that there will be "minor additional costs or impacts to the subsidy to operate the 7(a) Loan Program" but does not provide specific estimates. These "minor additional costs" are likely to be higher over time, as the new CA SBLCs reach the lending activity that established SBLC license holders currently provide.

With regard to the "Affiliation and Lending Criteria for the SBA Business Loan Programs" rule, the SBA similarly seeks to abandon guardrails that ensure responsible, prudent lender underwriting and minimize programmatic subsidy risk. Additionally, it seeks to eliminate the principle of management and control over another entity to prove affiliation, as well as to change the rules governing affiliation arising from ownership. These changes could allow for wealthier individuals, and large entities, to take advantage of SBA loan programs that are meant to provide support to small businesses who are not able to obtain credit elsewhere.

I strongly support increasing capital access to small businesses in underserved communities. However, it is questionable whether the SBA's rules will actually help increase access to capital for minority and underserved communities, and they very well could cause unintended financial harm. Instead, the SBA should work with congressional committees to modernize its lending programs and increase capital access in a manner that preserves necessary guardrails. We should not put struggling small businesses in a position to default on their loans. We should increase the availability of credit while simultaneously addressing the other financial, organizational, or technological issues that are inhibiting their growth to create jobs in their communities. That is what will truly position them for capital growth—and allow SBA loans to reach even more small businesses. The SBA entrepreneurial programs play a key role here as well; we must ensure that we are enabling these organizations to best coordinate resources, provide technical assistance, and work toward outcomes over output. I urge the agency to significantly revise or to rescind the corresponding rules.

Thank you.

Senate Committee on Small Business and Entrepreneurship Hearing
April 26, 2023
Follow-Up Questions for the Record for Mr. Patrick Kelley

Questions from Chairman Cardin

Underserved Communities

During the hearing, you referred to the underserved definition detailed in the Community Advantage (CA) Participant Guide. This underserved market definition includes businesses in low-to-moderate income communities, HUB Zones, rural areas, new businesses (open less than two years), businesses majority owned and controlled by veterans, and more; it does not include women and minorities.

You concluded that despite there being no requirement in the 7(a) program for lenders to lend a certain percentage of their loans to underserved markets, 7(a) lenders make 50 percent of loans to such markets. Furthermore, you stated that women and minorities will not be added to the underserved definition.

Women and minorities are not included in the underserved definition and the Administration's specific goal, as referenced in your response to our bipartisan letter, is to "expand the number of lenders who can provide loans to… women [and] minorities."

QUESTION 1:
How will you measure whether CA SBLCs or the newly licensed SBLCs are meeting your stated program goals?

To assess whether Community Advantage (CA) SBLCs or newly licensed SBLCs are meeting SBA program goals, the Office of Credit Risk Management (OCRM) will conduct reviews of each CA SBLC and SBLC as follows:

- Quarterly review of CA SBLC lending to ensure that at least 60% of their loans went to Borrowers who meet the Underserved Market Criteria (including race, gender, veteran status, or ethnicity);
- Quarterly Financial Statement Reviews (internally prepared balance sheet and income statement) to assess lender financial condition;
- Quarterly Capital Adequacy of SBLCs to assess regulatory compliance with SBA's capital requirements;
- Quarterly Review of CA SBLC Loan Loss Reserve Accounts to assess compliance with SBA's CA SBLC reserve requirements;
- Delegated Authority Reviews – comprehensive compliance-based reviews conducted by OCRM prior to each lender's delegated authority expiration date in order to determine if renewal of authority should be awarded to lender;
- Annual reviews of each CA SBLC and SBLC's audited financial statements (which are prepared by an independent certified public account). The audited financial

statements from CA SBLCs must include the CPA's assessment of the lender's compliance with the loan loss reserve requirements; and

- Risk-based reviews of CA SBLCs and SBLCs to ensure that lenders are in compliance with SBA Loan Program Requirements. SBA's Loan and Lender Monitoring System (L/LMS) and Lender Portal enables OCRM to track and analyze SBA Lender performance (such as early problem loans and delinquencies). SBA uses L/LMS to assist in prioritizing, planning, and conducting more in-depth reviews of higher volume lenders and to monitor SBA lenders between more in-depth reviews. In-depth reviews may include Limited Scope Targeted Reviews, Safety and Soundness Exams, or Delegated Authority Reviews.

SBA will also continue to publish documents related to our financial and operational performance.

QUESTION 2:
After a review of a 7(a) lender by the Office of Credit Risk Management (OCRM), the Administrator must deliver a written report to the lender not later than 60 days after the date on which the review is concluded. If not submitted within 60 days, the Administrator must notify the lender of the delay and the reason for the delay. **For the current 14 Small Business Lending Companies (SBLCs), in the last four years, how many of these entities were notified that their review reports would be delayed?**

OCRM conducted 50 risk-based reviews of the 14 SBLCs in the past four years (FY 2019-present). Fourteen (14) of the risk-based review reports were issued more than 60 business days after the conclusion of the review activities, which is what is required of OCRM by the Small Business 7(a) Lending Oversight Reform Act of 2018. All of the risk-based reports not issued within 60 days of the conclusion of review activities were for reviews that began during the height of the COVID-19 pandemic in 2020 and 2021, during which existing SBA staff were also assigned to assisting with delivery of work related to the Paycheck Protection Program (PPP).

QUESTION 3:
If there were delays, were the delays due to OCRM lacking the staff and resources to handle these reviews in a timely manner?

OCRM works to issue the risk-based review reports as expeditiously as possible. During 2020 and 2021, OCRM staff were also asked to help facilitate the effective delivery of the Paycheck Protection Program (PPP).

QUESTION 4: To handle the increased monitoring and oversight responsibilities the agency intends to utilize technology, such as artificial intelligence, to provide robust lender oversight. The Deputy Inspector General's testimony provided that to "effectively employ artificial intelligence, comprehensive and reliable data must be available and current." The testimony also mentioned that the loan information within SBA's Capital Access Financial System, which includes E-Tran for loan origination and servicing is not comprehensive. **What internal controls will the agency institute to ensure that the technology utilized will provide proper lender oversight?**

OCRM's lender risk frameworks (PARRiS for 7(a) & SMART for 504) combine SBA's Capital Access Financial System data with call report data from bank and credit union regulators, commercial and consumer credit bureau data for each SBA borrower, and macroeconomic data to create key performance indicators (KPI) and predictive models. Each KPI and model is reviewed and/or validated on an annual basis to ensure that it is meeting its intended purposes and performing at an acceptable level.

QUESTION 5: SBLCs generally receive a Safety and Soundness Examination at least biennially. All other SBA Supervised Lender, like CA lenders, are selected for examinations based on the size of their SBA portfolio and the risks associated with the lender. **Will the CA SBLCs be subject to a Safety and Soundness Examination biennially? And how many reviews will be conducted of these entities during the same two-year period?**

OCRM plans to conduct safety and soundness examinations (Examinations) for CA SBLCs that have lending activity and/or risk characteristics that require examination quality activities to prudently assess compliance and risk. Attributes that may contribute to a biennial examination include, but are not limited to:

- the amount of SBA share dollars outstanding (e.g., greater than $10.0 million),
- elevated risk profile based on portfolio performance and/or quantitative asset quality (e.g., elevated number of loans experiencing early default issues), and/or
- to test compliance with a Formal Enforcement Action (e.g., assessing the implementation and compliance with a capital directive).

Separately, review activities will be used to monitor risk, correct behavior, and ensure compliance with capital adequacy, asset quality, management quality, earnings, liquidity, and compliance with general Loan Program Requirements. Reviews are conducted at a greater frequency than examinations, require fewer resources, and are less invasive, which facilitates timely risk-identification and corrective action while allowing the CA SBLC to remain focused on delivering capital to America's small businesses.

During a two-year period, a CA SBLC will be subject to no less than 10 review actions. Review activities are conducted quarterly based on required submissions related to the CA SBLC's financial condition, legal and administrative proceedings, reports of change, and the like. These review activities are cost-advantageous to CA SBLCs with small dollar 7(a) loan portfolios as the review cost is spread across all 7(a) SBA Supervised Lenders as part of the annual fee schedule for SBA's oversight of 7(a) Lenders.

The CA SBLC will also be subject to at least one risk-based review per year that involves data analysis, an assessment of management and operations, and an inspection of 7(a) loan files. The only time this review activity would not be conducted is if the CA SBLC is subject to an examination that year. The current cost for this risk-based review, on average, is less than $5,000; comparatively, an examination typically costs more than $45,000. In addition, OCRM will internally perform a quarterly analysis of the data to identify any trends that indicate emerging risk with action taken when appropriate. Typical actions include conducting a risk-based review that has a narrow scope to focus on the identified risk.

QUESTION 6:

In the final SBLC Rule, SBA estimated the total biennial cost of the risk-based exams/reviews is currently approximately $50,000 to $150,000 per institution, with review costs correlated to the size of the SBLC's loan portfolio. **Has the agency assessed whether all the CA lenders that are being grandfathered into the CA SBLCs can afford those assessments, to include the initial $10,000 safety and soundness examination fee?**

The SBA performs a wide variety of risk-based reviews for CA and other Non-Federally Regulated Lenders (NFRL) to ensure adequate oversight at a cost that a smaller lender can afford. These include Quarterly Condition Reviews, Lender Profile Assessments (LPAs), Analytical Reviews, Targeted Reviews, and/or Full Scope Reviews. SBA also performs selective loan file reviews to ensure loans are underwritten and closed in compliance with loan program requirements.

QUESTION 7:

What outreach has been conducted to inform CA lenders that they will need to make the transition into a CA SBLC? And, what type of assistance will be provided to the CA lenders to help them with this transition?

Outreach has been conducted via an Information Notice on CA SBLC Conversion (SBA Information Notice 5000-846918, May 1, 2023), trade association conferences, and teleconference training and information sessions. Additionally, all current CA Pilot Program Lenders have received an email notification from CAloans@sba.gov with information about the grandfathering opportunity and an unexecuted Loan Guaranty Agreement (SBA Form 750) to be reviewed, completed, and signed.

As a result of this outreach, lenders responsible for more than 80% of CA loans have signed to enroll in the CA-SBLC program as of July 7, 2023 and we expect that number to increase.

QUESTION 8:

Character Criteria

I was pleased to see the Administration remove 'character' from the list of lending criteria in the final Affiliation Rule. We must ensure that criminal history, including as it relates to character considerations, must not be conflated with repayment ability. Justice-impacted individuals face many barriers to entrepreneurship, including limited access to capital, mentorship, and training.

During the pandemic, I advocated for justice-impacted individuals to be eligible for the Paycheck Protection Program (PPP). In 2021, I worked with the Biden Administration to further expand access for justice-impacted individuals by specifically eliminating the one year look back restriction. I'm particularly proud of changes to the CA Pilot Program that greatly expanded access for justice-impacted entrepreneurs, including removing the requirement to ask questions about criminal history to CA applicants on Forms 1919 and 1920.

Justice-impacted entrepreneurs are less likely to recidivate and are more likely to employ other justice-impacted individuals, leading to a multiplied positive impact for the individual and their communities. I hope to continue working with the Administration to pave the path for a new generation of justice-impacted entrepreneurs and small business owners.

In the final Affiliation Rule, the administration details that "SBA lenders may continue to make their own credit decisions based on the criminal background of an applicant and its associates." Does the administration have data on lending practices for justice-impacted individuals in the private sector?

SBA does not have private-sector data on lending practices for justice-impacted individuals. SBA continues to work to ensure equitable access to all SBA programs.

QUESTION 9:

Has the Administration considered limiting allowable criteria for 7(a) lenders when evaluating criminal history for borrowers, beyond removing the existing restrictions?

SBA is currently considering changes that would increase access to capital for justice-impacted individuals while providing oversight of taxpayer dollars through appropriate controls and processes to mitigate potential fraud, waste, and abuse. SBA expects to publish a notice of proposed rulemaking soon to collect public feedback on potential actions.

QUESTION 10:

Has the Administration considered not requiring questions about criminal history on 7(a) loan applications, as it already does for applicants to CA lenders related to Forms 1919 and 1920?

See answer to Question 9.

Questions from Ranking Member Ernst

QUESTION 1:

SBA Debt Collection Practices

Mr. Kelley, in the hearing you outlined that the COVID EIDL program SBA would have to set an offer in compromise and create a partial payment plan to offset losses to the taxpayer. **SBA Deputy Inspector General Shoemaker stated that $76.9 billion is at risk and of that $60 billion is past due. Have you reached out to every single borrower to ask for their ability to repay?**

Yes, SBA has reached out to every single borrower at the contact information that each borrower provided concerning the extension of the deferment to 30 months. Furthermore, SBA has been conducting scheduled outreach to every COVID-19 EIDL borrower the month before they roll off deferment to alert them to their resumed payment obligation. This outreach occurs via paper mail, emails, and automated phone calls, and outreach began before the first batch of loans came off deferment in October 2022. As a result, the SBA has made millions of attempts to remind borrowers of their payment due dates and amounts. The SBA will reach out to borrowers who are scheduled to come off deferment in the upcoming months to remind them about their payment due date and amount. Additionally, the following communication is being provided to delinquent EIDL borrowers:

- Automated phone calls are made weekly to delinquent borrowers starting at 30 days delinquency, twice weekly at 60 days delinquency, and thrice weekly at 90 days delinquency. A notice of Delinquency is sent at 25, 40, and, 60 days delinquent via email (a reply message in the portal).
- A Due Process Notice is sent at 60 days delinquent via paper mail and email.
- A Notice of Default and Acceleration is sent at 75 days delinquent via email (a reply message in the portal) or paper mail.
- At 90 days delinquent, an additional delinquency notice is sent.

QUESTION 2:How many borrowers and for what dollar amount have submitted an offer in compromise document?

We have received 45 requests for Offers In Compromise (OIC) to date. None of these requests were approved. They did not meet the criteria to qualify for an OIC as none of the loans had been liquidated and/or charged off.

QUESTION 3:
How many borrowers have not responded and are delinquent under $100,000?

As of May 30, 2023, 1,024,131 loans are under $100K (based off loan disbursed amount) and 60+ days past due.

QUESTION 4:
Is SBA planning on referring borrowers to the Treasury Offset Program?

Yes. Please see the letter to Senator Ernst on this issue dated April 26, 2023 for more detailed information including the consequences of non-payment, such as being added to Treasury's Do Not Pay System and reporting to credit bureaus.

At 120 days delinquent, eligible loans are referred to the Treasury Offset Program (TOP)and cross servicing. SBA has decided that COVID EIDL loans with a disbursed amount of $100,000 or less (except for any loan that appears to be or has been reported as fraudulent, false or involving misrepresentations) will not be referred to Treasury. SBA determined that the cost to collect exceeds the expected recovery. SBA has authority under 31 U.S.C. § 3711 to end collection on claims of not more than $100,000, and the decision to end collection was approved via SBA Form 606. However, borrowers who are not referred to Treasury will still receive negative credit bureau reporting, possible issuance of an IRS Form 1099-C, and will be reported to the Credit Alert Verification Reporting System (CAIVRS), which may impact future federal assistance. For COVID-19 EIDL loans with a disbursed amount greater than $100,000, borrowers and guarantors will be referred to TOP and Treasury cross servicing.

QUESTION 5:
Is SBA planning on seeking alternative collections methods for borrowers under $100,000?

It is not cost effective to refer these loans to third-party debt collection services because it would cost taxpayers more than we could recover.

SBA will service and liquidate the loans in accordance with SBA Loan Program Requirements, including processing payments received and responding to borrower inquiries. SBA will continue to process UCC financing statement modification and release requests. Depending on the circumstances, SBA will request a payoff or partial paydown if a charged-off Borrower requests a release or modification of the UCC financing statement. However, SBA will not actively pursue collection on the subject loans because the cost of collecting is likely to be more than the amount recovered.

Ending collection on a debt merely ceases active collection of the debt, but the debtor is still obligated to pay the debt. Upon issuance of an IRS Form 1099-C, the borrower is subject to any taxes as result of discharge of the debt. The reporting of the discharge of indebtedness on an IRS Form 1099-C does not affect the right of the creditor to collect a debt. An agency's determination to suspend or terminate active collection action on a debt does not prevent the agency from revisiting this determination and pursuing active collection action in the future. In accordance with 31 CFR 903.3(b)(2), a determination to end collection does not preclude SBA from, among other things, "[p]ursuing collection at a subsequent date in the event there is a change in the debtor's status or a new collection tool becomes available," "offsetting against future income or assets not available at the time of termination of collection activity," or screening future applicants for prior indebtedness. SBA may file a proof of claim and otherwise participate in any bankruptcy cases involving the subject loans. As stated earlier, borrowers who default on their loans will be ineligible for future federal payments. Borrowers in default may also have difficulty obtaining funding in the private sector as a result of the negative impacts to credit scores.

Additionally, SBA will not end collection on any COVID-19 EIDL of any amount that appears to be or has been reported as fraudulent, false, or involve misrepresentations.

Unanswered Questions to Previous Debt Collections Letter

QUESTION 6:
Mr. Kelley, the agency sent a response to my office the morning of your hearing that did not answer a single one of my questions. Please respond to the following questions.

What is the current amount of loans by number and dollar that are past due (30 days late) and are in default (90 days late)?

SBA responded to your inquiry on April 26, 2023. With respect to these questions:

Data as of May 30, 2023:

30+ Days Past Due:
Number of loans: 1,289,276
Dollar amount: $85,227,259,263.32 (based off loan disbursed amount)

90+ Days Past Due:
Number of loans: 1,024,149
Dollar amount: $61,499,470,271.87 (based off loan disbursed amount)

QUESTION 7:
Has the SBA made any attempt at contacting EIDL borrowers to assess their ability to repay their loans and, if not, why?

Yes. As discussed at the hearing, SBA has contacted borrowers about their obligations and is actively working with struggling borrowers to help facilitate repayment.

Additionally, the following communication is ongoing with delinquent COVID-19 EIDL borrowers:

- Automated phone calls are made weekly to delinquent borrowers starting at 30 days delinquency, twice weekly at 60 days delinquency, and thrice weekly at 90 days delinquency.
- Notice of delinquency is sent at 25-, 40- and 60-days delinquent via email (a reply message in the portal).
- Due Process Notice sent at 60-days delinquent via paper mail and email.
- Notice of Default and Acceleration sent at 75-days delinquent via email (a reply message in the portal); if no email, sent via paper mail.
- At 90-days delinquent, an additional delinquency notice is sent.

Furthermore, all COVID-19 EIDL borrowers may enroll in the MySBA Loan Portal to view and make payments. Those COVID-19 EIDL borrowers with a loan balance of $100,000 or less can click a link in the portal to instantly access the Hardship Accommodation Plan, which involves six months of payments at 10% of their normal payment amount. External-facing guidance on the Hardship Accommodation Plan is published on sba.gov/pay and sba.gov's Manage Your EIDL page. As of May 31, 2023, there were 59,917 Borrowers enrolled in the Hardship Accommodation Plan.

QUESTION 8:
Has the SBA made any attempt at contacting PPP loan borrowers who have not received forgiveness to assess their ability to repay their loans and, if not, why?

Borrowers may submit a loan forgiveness application for a PPP loan any time before the maturity date of the loan, which is either two or five years from loan origination depending on when the loan was issued. PPP loans are lender serviced. As such, lenders are responsible for contacting borrowers who do not receive full forgiveness or do not apply for forgiveness regarding repayment. Lenders are also responsible for collecting borrower loan payments and for submitting monthly SBA Form 1502 reports regarding the status of the loan and any payments received.

QUESTION 9:
Does the SBA intend to require EIDL and PPP loan program borrowers to repay their loans, regardless of their size?

All borrowers are required to repay their loans. Our April 25, 2023 letter to your office states: "SBA's policy is to collect on every loan and all borrowers are required to repay their loan." The letter further describes the borrower consequences for non-payment, including being ineligible for future federal assistance, being added to Treasury's Do Not Pay System, as well as negative impacts on their credit score that will impair their ability to obtain future financing in the private sector.

QUESTION 10:
The OIG has reported that SBA engaged the services of a third party to make recommendations around alternative means of collection within the EIDL and PPP loan programs. What were their recommendations and has SBA conducted a cost-benefit analysis of them? If not, why has SBA chosen not to conduct such an analysis? If so, what were the results of that analysis and does SBA intend to adopt any of the recommendations?

SBA contracted with a third party to perform a cost-benefit analysis of ending collection on PPP loans of $100,000 or less. The cost-benefit analysis is still underway.

QUESTION 11:
Has the SBA discussed or considered how their failure to collect will impact other federal programs if borrowers who have effectively defaulted are able to continue receiving federal payments or loans?

The Credit Alert Verification Reporting System (CAIVRS) was developed by the Department of Housing and Urban Development in June 1987 as a shared database of defaulted Federal debtors and enables identification of individuals who are in default or have had claims paid on direct or guaranteed Federal loans, or are delinquent or other debts owed to Federal agencies.

CAIVRS is one of about 20 databases currently available for use by federal agency programs and federally funded state-administered programs in the Do Not Pay (DNP) Portal operated by the Department of the Treasury. DNP is authorized and governed by the Payment Integrity Information Act of 2019 (PIIA) and several Office of Management and Budget (OMB) memoranda and circulars.

DNP is a collection of data sources to help agencies mitigate or eliminate improper payments by flagging payees who may not be eligible to receive Federal payments or engage in Federal programs. Federal agencies and federally funded state-administered programs must still apply their internal policies, regulatory requirements, legal obligations, and procedures to adjudicate DNP findings and ultimately determine whether payees are eligible and payments are proper. SBA is continuously working with owners of DNP data sources to add delinquent debtors to these databases and make such information available through DNP to, overall, detect and prevent improper payments.

QUESTION 12:
If the SBA decides to forgo these collections, do they intend to report the borrowers to Treasury for inclusion on the Do Not Pay list?

Yes. Please see the answer to Question 11.

Compliance with Bank Secrecy Act/Know Your Customer/Anti Money Laundering

In SBA response to the letter Chairman Cardin and I sent you regarding these rulemakings, SBA stated that all "7(a) lenders, including SBLCs, are required to comply with Bank Secrecy Act/Know your Customer/Anti Money Laundering standards (BSA/KYC/AML)." Committee staff have been unable to find any indication that this is true, even after looking through regulations governing 7(a) and multiple SBA SOPs.

QUESTION 13:
Where, specifically, in guidance, SOPs, or regulation does SBA indicate that compliance with BSA/KYC/AML is required of all lenders in the 7(a)-lending program?

Pursuant to 13 CFR 120.410(e), Federally-Regulated Lenders participating in the 7(a) lending program must be considered Satisfactory by their Federal Financial Institution Regulators, which includes compliance with all aspects of the Bank Secrecy Act (BSA).

Additionally, Small Business Lending Companies (SBLCs) and Non-Federally Regulated Lenders (NFRLs) participating in the 7(a) lending program have been subject to Bank Secrecy Act (BSA) requirements for almost 20 years. In 2001, Congress enacted the USA PATRIOT Act (P.L. 107-56), which amended the BSA to require financial institutions to adopt a customer identification program as part of their BSA compliance program. A Joint Final Rule was subsequently issued by the U.S. Department of the Treasury and various federal financial regulators requiring banks, savings associations, credit unions, and certain non-federally regulated banks to implement a customer identification program by October 1, 2003. At the recommendation of SBA's Office of Inspector General, SBA issued Policy Notice 5000-901 (effective December 23, 2003) requiring those SBA 7(a) and 504 lenders, including SBLCs, NFRLs and Certified Development Companies (CDCs), not covered by the Joint Final Rule to develop and implement a customer identification program that complied with the requirements of the Joint Final Rule on or before June 30, 2004. 7(a) lenders were advised that failure to implement a customer identification program could result in denial of liability or other enforcement actions and reminded 7(a) lenders that they or their borrower applicants could be subject to civil and/or criminal penalties for false statements made in connection with identity information and verification policies and procedures. The requirements of SBA Policy Notice 5000-901 were subsequently incorporated into SBA SOP 50 10 and can currently be found at page 157 of SOP 50 10 6.

More recently, under the Paycheck Protection Program (PPP), SBA issued an Interim Final Rule that required SBLCs and NFRLs to comply with the following underwriting and reporting requirements:

> *Entities that are not presently subject to the requirements of the BSA, should, prior to engaging in PPP lending activities, including making PPP loans to either new or existing customers who are eligible borrowers under the PPP, establish an anti-money laundering (AML) compliance program equivalent to that of a comparable federally regulated institution. Depending upon the comparable federally regulated institution, such a program may include a customer identification program (CIP), which includes identifying and verifying their PPP borrowers' identities (including e.g., date of birth, address, and taxpayer identification number), and, if that PPP borrower is a company, following any applicable beneficial ownership information collection requirements. Alternatively, if available, entities may rely on the CIP of a federally insured depository institution or federally insured credit union with an established CIP as part of its AML program. In either instance, entities should also understand the nature and purpose of their PPP customer relationships to develop customer risk profiles. Such entities will also generally have to identify and report certain suspicious activity to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).*
> *See, 85 FR 20811, 20815 (April 15, 2020). As all existing SBLCs participated in the PPP program, they were required to comply with these BSA underwriting and reporting requirements.*

See, 85 FR 20811, 20815 (April 15, 2020).

SBA has been monitoring lender compliance with the foregoing requirements through Targeted Reviews and will continue to do so during the regularly scheduled risk-based reviews performed on all SBA Supervised Lenders. Additionally, with respect to PPP loans, at the time of guaranty purchase, SBA may review a PPP lender's compliance with the BSA underwriting requirements applicable to PPP loans.

QUESTION 14:
Can you detail how, specifically, the SBA requires compliance by SBLCs and other 7(a) lenders with BSA/KYC/AML, how it conducts reviews of such compliance during examinations, and SBA's policies and SOPs on enforcement and monitoring of compliance with BSA/KYC/AML?

Please see the answer to Question 13 and SBA's response letter from April 26, 2023.

QUESTION 15:

A major concern with the lifting of the moratorium is the ability of OCRM to adequately conduct oversight of new SBLCs. You've said SBA anticipate adding only three new lenders in the first year, testifying that you believed SBA had the capacity to do so. Despite that, in its proposed rulemaking, SBA indicated that it expected current Community Access Pilot Program (CAPP) participants to be "immediately approved" if they apply to transition into the SBLC program. **How did you make the determination that OCRM has sufficient capability to regulate these additional SBLCs and what indications or metrics will the SBA use in the future to determine if it is sufficiently capable of conducting oversight of additional SBLCs?**

OCRM worked closely with the OCA leadership to determine what resources would be required to conduct oversight of additional SBLCs. For the three new SBLCs anticipated in 2023, no additional OCRM staff will be necessary. OCRM will oversee the new SBLCs in the same way that existing SBLCs are monitored.

OCRM has overseen the performance of the 14 existing SBLCs, as well as all other 7(a) and 504 lenders, for many years using a variety of statutes, regulations, SOPs, and technology tools. In recent years, SBA has implemented multiple actions to improve its ability to effectively oversee and monitor lender participants, including issuance of the Final 7(a) Lending Oversight Rule in response to the Small Business 7(a) Lending Oversight Reform Act of 2018. The publication of the SOP 50 53 2 for Supervision and Enforcement has strengthened lender oversight capability and the implementation of changes to the SBA Lender Risk Rating System uses a redeveloped model to assist SBA in calculating the risk of each 7(a) lender and Certified Development Company (CDC). The Loan and Lender Monitoring System (L/LMS) and the Loan Review Tool (LRT) are two technology tools that enhance SBA's ability to identify risk trends at an early stage to ensure rigorous oversight of lenders with elevated risk profiles.

QUESTION 16:

Does the SBA intend to transition existing CAPP participants to the SBLC program and, if so, how does it intend to effectively regulate an additional 108 SBLC participants, considering many of the requirements that limit the risk profile of CAPP participants will no longer be in place in the regulations?

OCRM already oversees the Community Advantage Pilot Program participants in the 7(a) Program, which are all categorized as SBA Supervised Lenders, so additional oversight will not be required as these existing participants transition to Community Advantage SBLCs.

Effective May 12, 2023, OCRM initiated a program to enable current CA Pilot Program Lenders to become Community Advantage Small Business Lending Companies (CA SBLCs). CA Pilot Program Lenders that choose to convert to CA SBLCs will execute an SBA Form 750, be required to have a minimum of 60% of their loans closed meet the underserved market requirements currently in place for the CA Pilot Program, and meet the loan loss requirements specified for the CA SBLC program.

Rulemaking Communications for questions 17-19

During the hearing you testified that you did not make any "promises or commitments concerning the standard operating procedures (SOPs) or agency procedural notices" in order to garner support for the final rule.

QUESTION 17:
After the NPRM was posted, did you speak to any possible stakeholders about the substance of the rule, agency processes, or otherwise that was not disclosed as part of the record?

QUESTION 18:
Did you make any promises, whatsoever, to individuals or organizations outside of Congress, related to these rules or how they would be implemented, whether through SOPs, licensure decisions, requirements for new Community Advantage SBLCs, or more general SBLC insurance and capital requirements?

QUESTION 19:
Did you ask any lenders, lender-affiliated organizations, or companies to publicly express support for the rule?

Answers to Questions 17-19: Now that Mr. Kelley has left public service, we would refer you to the answers that he gave to the Committee during his testimony.

Questions from Senator Hickenlooper

As you know, a recent Federal Reserve study shows that fintech lenders successfully made loans to zip codes with higher bankruptcy and unemployment rates than traditional lenders.

QUESTION 1:
How will this final rule responsibly expand the ability of additional fintechs to fill gaps in lending by SBA programs and get more dollars into the hands of underserved entrepreneurs?

Access to capital remains a challenge for too many entrepreneurs in underserved communities. SBA's lending programs have experienced a decline in small dollar lending, with loans under $150,000 dropping nearly 30% since 2016. Further, the 2022 Federal Reserve Banks Small Business Credit Survey showed that businesses need this capital, as two-thirds of businesses that sought funding had a financing shortfall. A lack of small dollar loans deprives startups and small businesses run by women, people of color, and rural Americans of funding they need to start and grow their businesses. The SBA is committed to addressing the market failure of declining small dollar lending by proposing and enacting rules that will cut red tape, reduce complexity, and increase the number of participating lenders.

The 14 current SBLCs will retain their licenses, and SBA will license up to three additional regular SBLCs, which will:

- Be regulated, supervised, and examined by SBA in accordance with the same oversight standards applied to today's successful and responsible SBLCs.
- Have a demonstrated historical performance of safety, soundness, and a strong regard for borrower financial health and protection prior to applying for the SBLC license.
- Be required to comply with all rules and regulations for 7(a) lending, including interest rate caps and fee structures.
- Expand the number of lenders who can provide loans, including loans to the hardest-to-reach small businesses, those owned by women, minorities, and veterans, and firms located in rural areas.

QUESTION 2:
How did the SBA incorporate the feedback from these letters into its final rule over the past 3 months?

SBA testified about the rules during Congressional hearings and responded directly to letters from members of Congress who raised concerns. Additionally, SBA reviewed letters from external stakeholders during the rulemaking process, and specific comments and feedback were addressed as part of the disposition of comments process during the rulemaking.

Committing to Reporting Requirements
Cooperation and information sharing between Congress and the Executive Branch is critical to ensuring that we are serving Americans as effectively as possible.

That's why when Sen. Tim Scott and I introduced legislation to remove the moratorium on SBLCs, we made sure to include congressional reporting requirements.

QUESTION 3:
Will SBA commit to providing Congress with regular reports detailing who SBLCs are lending to, the sizes of the loans they're making, and general program integrity?

SBA will continue to publish data on SBA loan programs online for public consumption at data.sba.gov. For information on SBA loans by lender, including SBLCs, see the 7(a) & 504 Activity Reports.

Supervising Capacity
It is crucial that the SBA, alongside state agencies, continue to responsibly supervise additional SBLCs once the moratorium has been lifted – as it has done for 40 years.

That's why when Sen. Tim Scott and I introduced legislation to remove the moratorium on SBLCs, we made sure to include an appropriation of the funding that is necessary to do so.

QUESTION 4:

If the SBA will not require additional resources, can you expand on the SBA's resource allocation plan to supervise three additional SBLCs, and the new Community Advantage SBLC program?
As stated in response to Question 15 above, OCRM worked closely with the OCA leadership to determine what resources would be required to conduct oversight of additional SBLCs. For the three new SBLCs anticipated in 2023, no additional OCRM staff will be necessary. OCRM will oversee the new SBLCs in the same way that existing SBLCs are monitored.

OCRM has overseen the performance of the 14 existing SBLCs, as well as all other 7(a) and 504 lenders, for many years using a variety of statutes, regulations, SOPs, and technology tools. In recent years, SBA has implemented multiple actions to improve its ability to effectively oversee and monitor lender participants, including issuance of the Final 7(a) Lending Oversight Rule in response to the Small Business 7(a) Lending Oversight Reform Act of 2018. The publication of the SOP 50 53 2 for Supervision and Enforcement has strengthened lender oversight capability and the implementation of changes to the SBA Lender Risk Rating System uses a redeveloped model to assist SBA in calculating the risk of each 7(a) lender and Certified Development Company (CDC). The Loan and Lender Monitoring System (L/LMS) and the Loan Review Tool (LRT) are two technology tools that enhance SBA's ability to identify risk trends at an early stage to ensure rigorous oversight of lenders with elevated risk profiles.

Questions from Senator Risch

Idaho bankers and credit unions have a proven track record of successful 7(a) lending to small businesses in Idaho because they have established deep relationships with the small businesses they serve. However, the final rules would allow new unsupervised entities like fintechs into the 7(a) program, effectively replacing local lenders and jeopardizing small businesses' access to capital. SBA's reasoning is that current lenders do not meet the underserved market gaps that exist.

However, SBA contradicts itself in its Congressional Budget Justification for FY24. You state that the Agency's FY22 goal for 7(a) loans to underserved markets was 43%, but the program far surpassed your own goal by making 68% of all loans to underserved markets.

Where is the failure in nearly 70% of all 7(a) loans going to underserved markets? SBA's own data says the program is succeeding.

I have concerns with letting fintechs into the 7(a) program because of the widespread fraud that took place with fintechs in the PPP program.

QUESTION 1:
Have you read the House Select Subcommittee's report on fintech facilitating the majority of fraud in PPP—yes or no?

Yes, SBA leadership and the Office of Capital Access leadership team have read the report.

QUESTION 2:
Are you aware of the conclusion from Congress—actually House Democrats—that fintech attracted fraudulent borrowers due to their lack of internal structures and systems in place around certain regulatory frameworks—yes or no?

SBA leadership and the Office of Capital Access leadership team are aware of the report's findings—including the serious problems of fraud and self-dealing by lenders and by companies who were paid fees by lenders to help PPP funds reach small business owners. SBA immediately suspended non-lenders Blueacorn and Womply from working with the SBA in any capacity and Administrator Guzman directed the Office of Capital Access to investigate all of the lenders – Benworth Capital Partners LLC, Capital Plus Financial LLC, Celtic Bank, Customers Bank, Cross River Bank, Fountainhead SBF LLC, Harvest Small Business Finance LLC, and Prestamos CDFI LLC, as well as the individuals and other related entities named in the report. More information is available in SBA's press release on the report.

QUESTION 3:
Are you aware of the House report's conclusion that fintech's structure attracted fraud?

The conclusion of the report supported the SBA OIG's findings that the previous Administration did not have proper controls in place to prevent fraud:

> *On the day that the SBA began issuing PPP loans, the SBA OIG warned that the program's structure—specifically, requiring limited documentation from loan applicants—had resulted in inappropriate or unsupported loan approvals in past SBA programs... The SBA OIG would later determine that the SBA under the Trump Administration did not heed their early warnings.*

Further, the report concluded that some fintech companies fell short of their responsibilities in administering PPP. In particular, the report found that some PPP lenders, including banks and CDFIs, relied on non-lender financial technology firms—primarily two companies, Womply and Blueacorn—that did not "implement systems capable of consistently detecting and preventing fraudulent and otherwise ineligible PPP applications."

QUESTION 4:
The SBA proposed rule on affiliation removes practical guardrails around a government-backed loan portfolio, hoping that lenders will still behave prudently even without a consistent set of criteria that were put in place for a reason – to reduce risk in a portfolio backed by the federal government. **Is it correct that every lender could have different definitions of what is appropriate and prudent, especially if we are talking about a non-federally regulated lender?**

When making a loan, lenders must consider a borrower's ability to repay their loan. What SBA is seeking to address is eliminating unnecessary burdens that make it more costly and therefore more difficult for lenders to be able to effectively provide small dollar loans to small businesses. SBA's OCRM reviews the lending policies for all non-federally regulated lenders at the time of application to participate in SBA lending, and further when conducting lender oversight activities.

Questions from Senator Young

The SBA's new lending rules significantly alter underwriting criteria for lenders, including regulated banks and unregulated fintechs, introducing a "do what you think is prudent" approach.

QUESTION 1:
How can these changes to the underwriting criteria be reconciled with the emphasis on protecting the American taxpayer, particularly in light of recent bank failures?
When making a loan, lenders evaluate a borrower's ability to repay the loan from the operations of the subject small business. What SBA is seeking with these changes is to eliminate unnecessary burdens that make it more difficult to access an SBA-backed loan.
OCRM will assess the effectiveness of a lender's underwriting through its risk-based reviews.

In addition, the partnership that SBA has with the primary federal regulators is particularly critical when an institution suffers a severe issue or a failure. As with Silicon Valley Bank (SVB) and Signature Bank, SBA loans are often a small fraction of a bank's overall portfolio. Nevertheless, SBA worked closely with the on-site regulatory teams during each of these events to ensure that the PPP, 7(a), and Third Party Lender (TPL) loans that combine with 504 loans were prioritized and well-managed during their transition to the successor bank. This is similar to the process that occurs as a result of bank mergers and acquisitions, which occur frequently. The small business borrowers who received SBA-backed loans from SVB and Signature are now being serviced by First Citizens Bank and Flagstar Bank.

As a result of these collaborative efforts, the SBA's exposure to the banking entities that failed is minimal.

QUESTION 2:
What anti-fraud measures will be implemented in light of the agency's modification to its longstanding underwriting criteria?

SBA cannot publicly disclose details about the fraud review that will be incorporated into the business loan programs. However, SBA will screen for fraud indicators using a variety of best-in-class government and private sector databases before a loan is disbursed to protect taxpayer funds.

QUESTION 3:

Since the release of the Inspector General's report in September 2022, has the agency attempted any action recover outstanding fraudulent PPP loans under $100,000, such as referring borrowers to credit reporting bureaus?

Yes. As discussed at the hearing, SBA is referring borrowers who default on their PPP loans to credit bureaus as well as Treasury's Do Not Pay System. Please see SBA's April 26, 2023 letter to Ranking Member Ernst. The letter further describes the consequences for non-payment—including being ineligible for future federal assistance; being added to Treasury's Do Not Pay System; and having negative impacts on credit score—that will impair their ability to obtain future financing in the private sector.

Additionally, SBA is referring all loans identified as potentially fraudulent to SBA OIG for criminal investigation and recovery.

QUESTION 4:

The SBA has claimed on several occasions that the rules will expand capital opportunities for underserved businesses by lifting the moratorium on licensing new SBLCs. **What requirements do the rules establish for regular SBLCs to focus on or reach underserved markets, and are there specific accountability measures for these new lenders?**

SBA does not require regular SBLCs to target underserved businesses. However, as many underserved small businesses have little or no regular business banking relationships, often the need for capital is sought through non-traditional sources.

QUESTION 5:

In the final rules, the SBA will determine the maximum loan amount eligible for credit scoring, without specifying a particular dollar limit. **Can you explain the decision-making process for setting this maximum loan size and whether it will be determined on a lender-by-lender basis?**

For over 10 years, SBA has applied the SBSS Credit Score (FICO Liquid Credit) in the 7(a) Small Loan processing method for loans of $350,000 or less. SBA reviews loan performance relative to score levels and finds a high correlation between scores and loan performance. This Score has been applied to larger loans reflecting consistent outcomes of its predictability.

QUESTION 6:

Without clear-cut guardrails in place, lenders may feel uncertain about their credit underwriting process. **In the event of a loan default and subsequent loan purchase, how can lenders be confident that the SBA will deem their credit underwriting process adequate?**

SBA will determine eligibility for all 7(a) and 504 loans beginning August 1, 2023, prior to disbursement through an automated eligibility check that uses a variety of best-in-class government and private sector databases. Additionally, OCRM will review the credit policies of each lender as part of the ongoing risk-based review process. The loan files reviewed for each lender will be tested for compliance with their credit policy and prudent lending criteria as determined by SBA. Concerns will be communicated to the lender and corrective actions required to ensure their compliance.

Questions from Senator Kennedy

SBLC Moratorium and Removal of the Loan Authorization Requirement

QUESTION 1:
Do you believe that SBA's Office of Credit Risk Management can adequately assess risk and serve as the primary regulator to examine and regulate multi-million-dollar fintech firms?
Yes. By lifting the cap on regular SBLC licenses, SBA will be able to admit additional lenders aligned with the agency's mission. SBA will begin by issuing up to three additional SBLC licenses to lenders with demonstrated historical performance of safety and soundness, and a strong regard for borrower financial health and protection. Administrator Guzman has made clear that SBA's objective is to increase the number of lenders serving the hardest-to-reach small businesses, including women, minorities, veterans, and rural firms, at no cost to the taxpayer. SBA is a modern, technology-forward agency that has the capacity to undertake oversight of three additional SBLCs by leveraging the talented agency staff along with private sector contracts to ensure appropriate oversight for all lenders.

QUESTION 2:
Why implement the SBLC moratorium on approving additional SBLCs? Was it not because of the implosion and failure of 3-4 of the SBLC license holders, such as Money Store and Heller? What is going to prevent these future failures?

The SBLC moratorium was originally instituted in January 1982 because of concerns about resources at the Agency. Since 1982 when SBA imposed the moratorium on licensing new SBLCs, there have been more than 60 different holders of the 14 authorized SBLC licenses. We are making these changes because SBA is a modern, technology-forward agency that has the resources and technology to adequately supervise three additional SBLCs. The agency has successfully overseen the transition and operation of various organizational structures of SBLC entities.

Expanding Access to Rural Small Businesses

Rural small businesses are often faced with disproportionate obstacles when trying to secure capital to develop and grow their small businesses.

QUESTION 3:
What avenues has the office of Capital Access pursued in order to ensure that small businesses, in rural communities, are receiving the capital that they need in order to kickstart their businesses?

SBA has developed financial literacy and skill-building curricula to assist entrepreneurs and small businesses in remote communities in identifying resources and preparing to request capital. SBA is removing collateral requirements for loans up to $50,000, which will make it easier to provide small businesses in rural areas more efficient delivery of small dollar loans. Additionally, SBA has conducted a Rural Pilot Program which authorized CDCs in the 504 Program to expand into rural regions beyond their immediate market to serve those businesses.

Office of Inspector General
U.S. Small Business Administration

May 17, 2023

The Honorable Ben Cardin
Chairman, Senate Committee on Small Business and Entrepreneurship
United States Senate
428A Russell Senate Office Building,
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your May 3, 2023 letter requesting written responses to additional questions as part of my testimony before the Senate Committee on Small Business and Entrepreneurship. The hearing was held on Thursday, April 26, 2023, and was titled "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital."

I am pleased to provide the enclosed written responses to the Committee's questions. If you have any questions, please contact our office at (202) 205-6586.

Sincerely,

Sheldon Shoemaker

Sheldon Shoemaker
Deputy Inspector General

Cc: The Honorable Joni Ernst
Ranking Member

Enclosure

Questions for Mr. Sheldon Shoemaker
Deputy Inspector General, U.S. Small Business Administration

April 26, 2023: Senate Committee on Small Business and Entrepreneurship Hearing titled "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital"

Questions from Ranking Member – Senator Joni Ernst

Fraud Referrals

During the hearing, Mr. Kelley stated SBA believes $40 billion is the fraud estimate on loans disbursed and $60 billion of attempted fraud totaling $101 billion. SBA claims they have referred over 3 million instances of attempted fraud on disbursed loans and 3.6 million applications to the SBA Office of Inspector General.

1. **Has the SBA referred over 3 million instances of fraud on disbursed loans?**

   SBA has made numerous referrals of alleged fraud to OIG; however, OIG is unable to validate the SBA assertion based on the information provided. With the various means used for what SBA may be considering a "referral," we are unable to aggregate the number of complaints in our system that are linked to the figures stated by the SBA.

   SBA's referrals are sent to OIG in various ways such as via email, on spreadsheets uploaded to a secure collaboration center, or via complaints the SBA submits directly into the OIG Hotline. Often, what SBA considers a referral is not always an actual complaint submission and is difficult to track.

   The spreadsheets that SBA provides encompass information they may have received from their own fraud reviews, ID theft submissions, information obtained from financial institutions, as well as information obtained from OIG and/or other law enforcement agencies. For example, the spreadsheets include applications that were flagged for fraud based on the over 90,000 EIDL file requests from law enforcement agencies. These should not be considered as referrals by SBA as they are already ongoing investigations.

2. **Has the SBA Inspector General assessed these 3.6 million loan applications and made recoveries of any kind?**

   As stated in the above response, OIG is unable to validate the SBA assertion based on the information provided. OIG does have access to SBA information systems and is able to further its investigative inquiries and data analytics efforts to root out fraud.

   Although, we are unable to determine the exact number of recoveries that can be associated with SBA referrals; to date, OIG is proud to report that through our "whole of government" approach, working collaboratively with agency and law enforcement partners, we have recovered the following:

- $ of restitution ordered: **$478,534,813.17**
- $ of recoveries (for fraud specifically, if available, and key entity responsible):
    - Assisted U.S. Secret Service has resulted in the seizure of more than $1 billion stolen by fraudsters from the EIDL
    - Assisted financial institutions in the return of another $8 billion to SBA's EIDL program
    - Administrative Recovery: **$36,046,051**
    - Asset Seizure/Forfeiture w/ Joint Agencies: **$399,839,264.00**
    - Cost Avoidance: **$123,149,796.98**
    - Over $20 billion in EIDL funds paid back by borrowers prior to the deferment period ending

3. Can you summarize the PPP forgiveness review process?

A borrower can apply for forgiveness once all loan proceeds for which the borrower is requesting forgiveness have been used any time up to the maturity date of the loan. If borrowers do not apply for forgiveness within 10 months after the last day of the covered period, then PPP loan payments are no longer deferred, and borrowers will begin making loan payments to their PPP lender. There are two processes for forgiveness: Direct and Non-Direct.

Direct Forgiveness Process

- Borrowers whose lender is participating in direct forgiveness, must use the SBA forgiveness portal.
    - Loans $150,000 or under
    - Questions in the portal correspond to those asked on SBA form 3508S.
    - The 3508S does not require borrowers to provide additional documentation to show the calculations used to determine their loan forgiveness amount. However, SBA may request information and documents to review those calculations as part of the loan review or audit processes.
- Platform sends forgiveness application for lender decision.
- SBA automated review (potentially, manual, as well)
- Payment
- SBA manual review (if selected)

Non-Direct Forgiveness Process

- Borrowers whose lender is NOT participating in direct forgiveness, forgiveness application (and related supporting documentation must be submitted through the lender. See 3508/3508EZ details above for what is required to be submitted.
- When a borrower submits SBA Form 3508 or Lender's equivalent form, the Lender shall:
    - 1) confirm receipt of the borrower certifications contained in the SBA Form 3508 or Lender's equivalent form;

  - 2) confirm receipt of the documentation the borrower must submit to aid in verifying payroll and nonpayroll costs, as specified in the instructions to the SBA Form 3508 or Lender's equivalent form;
  - 3) confirm the borrower's calculations on the borrower's SBA Form 3508 or Lender's equivalent form;
  - 4) confirm that the borrower made the calculation on Line 10 of the SBA Form 3508 or Lender's equivalent form correctly, by dividing the borrower's Eligible Payroll Costs claimed on Line 1 by 0.60.
- Lenders are expected to perform a good-faith review, in a reasonable time, of the borrower's calculations and supporting documents concerning amounts eligible for forgiveness.
- Lender must complete the review of the application and issue a decision to SBA, along with the required documents, not later than 60 days after receipt of a complete application from the borrower.
- SBA automated review (potentially, manual, as well)
- Payment
- SBA manual review (if selected)

4. Do you have concerns with loans that are suspected to be fraudulent and were not manually reviewed and have been forgiven?

Yes; based on OIG's preliminary analysis, the majority of forgiven PPP loans were auto reviewed which presents significant concerns considering the lack of internal controls and red flag indicators of fraud in the origination of the PPP loans. The forgiveness phase of PPP provided an opportunity to verify information attested to by self-certification during the loan origination phase.

OIG is executing a robust oversight plan to oversee SBA's pandemic response programs, and our investigative staff has hundreds of active investigations into suspected PPP fraud. OIG's oversight of the PPP and EIDL programs combined has resulted in 860 indictments, 687 arrests, and 486 convictions as of March 2023. Currently, our office has ongoing investigations that include PPP loans that were forgiven and auto reviewed.

5. What kind of process does the Inspector General have to go after funds that have been erroneously forgiven?

OIG does not have asset forfeiture authority, and as such, we rely on our law enforcement partners (such as the U.S. Secret Service) that have such authority to perform such actions. Through the utilization of task forces and other "whole of government" collaborations, OIG works in partnership with other agencies and law enforcement organizations with the authority to recoup taxpayer dollars and bring wrongdoers to justice via civil settlement, criminal restitution, forfeiture, and/or voluntary repayment by the borrower.

OIG has performed work to assess SBA's process to return PPP funds using regulatory authorities. This report will be issued soon and will highlight concerns of lack of formal processes.

Office of Credit Risk Management Capacity

The Office of Credit Risk Management has twenty-nine employees. Only four employees are assigned to oversee these SBLCs, and two of these positions are vacant.

6. **As recent as 2020, SBA stated they did not have the resources to oversee additional non-federally regulated lenders. In the opinion of the Inspector General, has anything changed?**

   OIG believes the concerns expressed in the 2020 rulemaking on the "SBA Supervised Lenders Application Process," pertaining to administrative resources needed to prudently regulate and oversee non-depository lenders with a nationwide 7(a) lending platform, were well founded. OIG's Report 23-05 found oversight staffing levels within OCRM decreased from 42 to 26 employees, or by 38 percent. This staff reduction could affect SBA's FY 2023 goal for oversight reviews, which help ensure lender compliance with program requirements.

   OIG agrees that technology and automated processes can augment oversight capacity; however, OIG Report 20-03 found OCRM lacked a comprehensive database to manage its high-risk lenders to ensure performance of all planned reviews, implementation of risk mitigation actions, and identification of noncompliant lender and systemic material weaknesses. OIG offered a recommendation to develop and implement such a database, and this recommendation remains open with a target date of September 30, 2023. According to SBA, OCRM continues to work with SBA leadership to define the requirements for the database or document management system and authorize its funding. OCRM's plan to develop a database or document management system to assist in managing oversight activities for high-risk lenders is awaiting prioritization for both resources and funding. Of note, SBA's risk-based oversight model considers all SBA Supervised Lenders as high-risk.

Artificial Intelligence Transparency

I am concerned about transparency and accountability with the use of artificial intelligence and machine learning algorithms.

7. **Would the SBA IG and the Office of Credit Risk Management have visibility into propriety algorithms used in fintech underwriting and processing of loan applications?**

   There are legal means for SBA and OIG to gain access to proprietary algorithms, which could occur as part of a typical oversight or investigation. The review of such algorithms would require highly technical resources. OIG is unaware of any SBA rulemaking that addresses such technology and relies on lenders participating in its programs to exercise oversight over its lending service providers. Given SBA is proposing that lenders rely on their like-credit policies for similarly sized 7(a) loans, it is conceivable that there would be an equal number of unique algorithms to the number of lenders in the SBA lending programs.

<u>Banking Regulations/PPP Fintech Fraud</u>

SBA wrote in a letter to Chairman Cardin and I that all 7(a) lenders, including SBLCs, have to comply with Know Your Customer, Bank Secrecy Act, Anti Money Laundering and federal banking requirements.

8. **Does the SBA have the enforcement capacity to ensure that fintech's comply with these requirements?**

   SBA's existing enforcement capacity likely would be challenged to meet the oversight needs to ensure compliance with the regulatory framework. OIG Report 23-05 highlighted staffing within the Office of Credit Risk Management (OCRM) as an area of risk, which is especially significant in context of the stated basis of the 40-year moratorium on additional SBLCs—necessary administrative resources. Such oversight resources also would be needed in monitoring regulatory compliance of an expansion of lender service providers in the loan programs, in this case financial technology companies that may engage in lender functions related to SBA business loans or loan portfolios for compensation from the lender.

   OIG Report 15-06 found that improvement is needed in SBA's oversight of lender service providers. Though recommendations from this report are closed, OIG continues to monitor SBA's oversight of lender service providers annually in our Top Management and Performance Challenges report (OIG Report 23-01). The report further highlights the risk associated with lender service providers and the importance of SBA continuing to evaluate performance and act when necessary to effectively reduce the incurred risks.

   SBA has the responsibility to provide oversight of its Supervised Lenders and has corresponding enforcement authority for noncompliance matters. SBA should ensure it has sufficient personnel and processes to provide adequate oversight of lenders utilizing financial technology companies as lending service providers. SBA should make clear the Bank Secrecy Act and Anti Money Laundering regulatory frameworks are requirements of its Supervised Lenders and include compliance checks within its onsite inspection procedures.

9. **Are you concerned that for-profit non-depository lending institutions who made PPP loans will conduct fraud in 7(a)?**

   Fraud concerns are equally present in both depository and non-depository lending institutions. OIG believes SBA must have robust internal controls in place to promote integrity within its Supervised Lender programs, which include robust oversight and monitoring requirements of their lending service providers. Weak internal controls do not provide the necessary assurance that only eligible borrowers gain access to SBA programs, making them susceptible to fraud and improper payments.

<u>Affiliation Compliance Shift to Lenders</u>

As part of their affiliation rule changes, the SBA not only eliminated the principle of control from their consideration of affiliation, but also intends to require lenders to conduct analysis of a business's affiliations. They claim this is reasonable due to the elimination of control considerations, making it easier for lenders to ensure compliance with the remaining affiliation standards. Among these is a simple ownership test in the case of affiliation.

10. **Why is it important to consider control of one business over another in determining affiliation, and is a simple test of ownership sufficient to prevent the participation of larger firms in SBA lending programs?**

    A simple test of ownership does not capture all scenarios that would allow for affiliated entities to gain access to SBA lending programs. The determination of affiliation is necessary to ensure that an applicant is 'small' for purposes of eligibility for SBA financial assistance and to ensure that the applicant (including affiliates) does not exceed the maximum guaranty amount available. However, SBA's rule is specifically removing the principle of control of one entity over another as a separate basis for finding affiliation. The stated reason is "because the concept of control as it exists requires understanding and expert consideration of business entity relationships well beyond what is owned by the applicant business or its owners."

    For example, OIG's Report 18-13 illustrates the finding of 7(a) loans made to chicken 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 our office 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. 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. As a result, from FY 2012 to FY 2016, SBA guaranteed approximately $1.8 billion in loans that may be ineligible.

    OIG's findings in this review hinged on the concept of affiliation through control, and in the SBA pending final rule, this affiliation criterion is removed. Without a requirement to consider control as an affiliative component, a lender potentially would simply view the chicken grower as the owner, absent any subsidization that the 7(a) loan would provide to the operations of the large companies that are controlling the chicken grower's business.

11. **Are lenders capable of ensuring compliance with SBA affiliation tests, especially in light of Associate Administrator Kelley's admission during the hearing that lender-enforced affiliation compliance led to over 200 instances of ineligible loans being made to applicants?**

    Yes; however, OIG prior work in the lending programs indicates that clear requirements and timely communication with lending partners mitigates risk of compliance errors, SBA's Franchise Directory provided a pre-screened list of franchise agreements that lenders could rely upon to expeditiously reference to ensure affiliation concerns were not present. Assessments of "control" in context of affiliation does require an in-depth analysis and understanding to ensure the small business owner is able to operate their business independently. The expertise to make such determinations exists within the lending community, and clear guidelines from SBA and pre-screened franchise agreements can reduce the determination burden.

Questions for Mr. Sheldon Shoemaker
Deputy Inspector General, U.S. Small Business Administration

April 26, 2023: Senate Committee on Small Business and Entrepreneurship Hearing titled "Oversight of SBA's Implementation of Final Rules to Expand Access to Capital"

Questions from Committee Member – Senator Jim Risch

I am concerned that the SBA does not have the capacity to provide oversight over these new, non-regulated lenders, many of which will be fintechs. The Office of Credit Risk Management has only 4 employees designated to oversee Small Business Lending Companies and has a staff vacancy rate of 38 percent.

1. **Mr. Shoemaker, your office has confirmed that the Office of Credit Risk Management does not have the bandwidth to oversee how fintech uses artificial intelligence and algorithms for automated underwriting and loan application processing. Can you explain how this lack of oversight would jeopardize the integrity of the 7(a) loan program and open it up to fraud and abuse?**

   SBA Supervised Lenders are regulated by SBA, as opposed to banking regulations and insurances. OIG Report 23-05 has highlighted staffing within OCRM as an area of risk, which is especially significant in context of the stated basis of the 40-year moratorium on additional SBLCs—necessary administrative resources. Such resources also would be needed in lender application reviews relative to credit policies and continuing oversight of this important program aspect.

   OIG believes robust internal controls promote integrity within its Supervised Lender programs. A sound internal control environment includes robust oversight and monitoring requirements, which would include lenders' oversight of their lending service providers. Internal controls within the lending processes that do not provide assurance that only eligible borrowers, such as Bank Secrecy Act's Know Your Customer regulations, make programs susceptible to fraud and improper payments.

   OIG's work has increased transparency on these significant risks and inform the program decisions under consideration at present. Solid rules and regulations, strong internal controls, and an effective process for oversight and monitoring can mitigate risk and lead to efficiency and effectiveness.

Senate Committee on Small Business and Entrepreneurship Hearing
April 26, 2023
Follow-Up Questions for the Record

Questions for Ms. Hilda Kennedy

Questions from:

Senator Hickenlooper

Office of Community Financial Institutions

A recent GAO report demonstrates that prioritizing community financial institutions successfully increased access to loans for underserved small businesses participating in federal lending programs.

QUESTION 1:

Would an office at SBA dedicated to supporting community financial institutions, and advocating on their behalf, help further expand access to capital in underserved communities?

Hilda Kennedy Answer

Senator Hickenlooper, I have thought about this question a lot since AmPac is a partner in all of SBA mission lender loan programs, including 504, Community Advantage and Micro-Loan, as well as a CDFI. While most SBA non-profit lenders are laser focused on economic development and job creation, and serving small businesses who are unable to obtain capital elsewhere on reasonable terms, CDFI's were established to focus on underserved communities or Target Markets with a metric of service to these communities tied to their ability to maintain their status as a CDFI.

I have often thought about the benefit of a collaborative liaison between SBA and Treasury that would work to collectively enhance the impact of serving small business to fulfill the legislative intent of Congress when they adopted the Small Business Act of 1953 establishing the SBA to provide programs that target "...certain groups in the United States [who] own and control little productive capital because they have limited opportunities for small business ownership."

The Community Development Banking and Financial Institutions Act was adopted by Congress in 1994 to create the Community Development Financial Institutions Fund to promote economic revitalization and community development through investment in and assistance to community development financial institutions, including enhancing the liquidity of community development financial institutions.

Community Advantage lenders, now CA SBLCs, and those who wish to join the program, face capitalization issues that prevent them from reaching their full potential to serve businesses with a reliable and consistent resource for capital that can be leveraged for additional private sector investment. The partnership between a CDFI and an SBA lender could have far-reaching impact by matching the capital from the CDFI with the SBA government backed guarantee, or for micro loans, the critical technical assistance (TA) funds, which are essential to the support of businesses seeking lower dollar capital.

Access to Capital

At least 83% of entrepreneurs do not use bank loans or venture capital to start their businesses, and instead rely on savings or personal credit cards.

QUESTION 2:

How do community financial institutions like yours support entrepreneurs that are struggling to access capital?

Hilda Kennedy Answer

CDFI's provide alternative financing that traditional financial institutions, like banks, typically do not provide to small businesses either because it is outside of their credit box, smaller than their bank wishes to lend, or the business is a start-up or emerging business that does not have enough credit history. Banks often provide grants or investments to CDFI's to meet their CRA requirements.

Additionally, CDCs provide capital through SBA's mission-based loan programs, which are intended to address private market gaps in capital access for small businesses, and particularly, socially and economically disadvantaged businesses.

AmPac supports businesses struggling to access capital in three ways:

- **Access to Capital** – AmPac provides affordable loans to businesses ranging from $5,000 - $350,000 through the SBA partnership and as a CDFI. In addition, AmPac assists businesses seeking a 504 loan to stabilize their business costs by buying a commercial building to operate within 51% of the building for the business. To encourage women and BIPOC businesses, and first time commercial real estate owners buying property in a HUBZone, Persistent Poverty area, or LMI Community, AmPac provides 50% of the minimum down payment up to $100,000.
- **Access to Coaching** – AmPac provides wrap around services to its business clients, with drop-in office hours with the Small Business Development Center (SBDC), a weekly consultant meeting in the AmPac office, and a Spanish speaking small business consultant also meeting in the office once per week. AmPac hosts business incubator and business accelerator programs, along with a Leap to Launch Entrepreneur Development program.

- **Access to Community** – AmPac launched a mobile app with 24-7 on-demand training courses for businesses, along with opportunities for businesses to book meeting space or office hours, or to use the office address as a business address.

Senate Committee on Small Business and Entrepreneurship Hearing
April 26, 2023
Follow-Up Questions for the Record

Questions for Mr. Chris Pilkerton

Questions from:

Ranking Member Ernst

Small Dollar Lending

During the hearing, multiple members asked whether this new rule would disincentivize new entrants into the SBLC program, whether prior mission-based lenders in Community Advantage or new SBLC licensee, from making small-dollar loans to businesses.

QUESTION 1:

Will these rules as they stand encourage small dollar lending within the 7(a) program?

While giving new lenders access to the SBA license and associated government guarantee will most likely lead to more lending, that certainly does not mean it will prioritize responsible small dollar lending. From a purely economic perspective, traditional lenders do not typically make as many smaller dollar loans, so the financial incentive to do so under the 7(a) program is limited to any applicable requirements. Unfortunately, the published final rule did very little to provide the public with independent data or research to support such a position or recommend and any additional ways to encourage it. Organizations like community development financial institutions (CDFIs) will continue this important work, but they are not likely to be the organizations that would receive these new SBLC licenses associated with the lifting of the moratorium. An additional point to consider here is that the rule does not speak to the standards of responsible lending that these new SBLC entrants will be governed. Lenders not only need strong internal controls and risk management systems, but must also be committed to responsible lending standards that are critical to supporting these small business borrowers. This is particularly important for those lenders that potentially may not have previously had any other state and/or federal regulator. The SBA guarantee is there to mitigate lender risk, but it should not be "bait" to put a borrower into an irresponsible loan. This country is not that far removed from the mortgage crisis, and we all recall how that impacted so many families and communities. Many of those loans proved to be irresponsible products that led to foreclosures and bankruptcies. And now, with just a click of the button, a small business could be in the same position—all because of a lender with an SBA approved icon on their website.

With respect to the new Community Advantage SBLC program, there are several points to consider. The current Community Advantage (CA) program lenders are only used to lending up to $250,000 (and more recently $350,000) in a particular geographic area, and now they will presumably have the ability to lend up to $5 million on a single loan nationwide. While this presents opportunity, it also envisions very different lending protocols, scale and associated risk and operational processes. As the rule states that all current CA lenders will be grandfathered into this program, a dedicated line of funded technical assistance should be in place to ensure that these lenders are prepared to take on this role. Further, if all current CA lenders become CA SBLCs, technically there will be no more CA lenders—at least at that time. If that program doesn't add new lenders, twelve years of thoughtful agency and congressional CA lending program development will be wasted because the program will essentially be dormant. It is of course up to Congress as to whether this program should be made permanent, but with no lenders, there will be little incentive to even have that conversation on permanency.

As previously mentioned, we unfortunately do not know a lot from the rule, which presents another concern—oversight. As of this response, the procedures around this program are not clear, but the rule states that the agency will handle these lenders on a "case by case" basis by the Administrator and Associate Administrator for the Office of Capital Access. This implies that political leadership will make such quantitative decisions, such as loan loss reserves and lender capital levels, at the individual lender level. The inability to have consistent criteria here will be a further burden on the examination work of the hardworking career professionals within the SBA's Office of Oversight and Credit Risk Management (OCRM). All of this would be on top of the approval and monitoring of new SBLC entrants and less than optimal staffing levels for this office. I strongly encourage that Congress take efforts to independently assess the needs of OCRM and ensure that it has adequate funding so that these committed career professionals can ensure the integrity of the lenders and this taxpayer-funded government guarantee program.

Affiliation Rules/Franchise Directory

The elimination of many of the current affiliation tests, including the principle of control, and the related decision to discontinue the publication of the franchise directory was a bipartisan concern during the hearing, due to the possibility that it could open the door for larger businesses making use of SBA lending programs they were not intended to access.

QUESTION 2:

Why is it important to evaluate the degree of control when considering whether an applicant is affiliated with another business, especially in the cases of franchises?

Franchises are a distinctive pathway to small business ownership. They are unique organizations that provide something of a "playbook" for many entrepreneurs to own, operate and scale a proven business model. And while most of these businesses come with sample procedures and manuals to serve as reference tools for the entrepreneur, the SBA funding element must consider the statutory language of the Small Business Act, which defines a small business as "independently owned and operated." Given that this is the word-for-word legal construct in the original implementing legislation, its intent is very clear. That said, while franchisors provide many tools for the franchisees to utilize, if the franchisor were to have operational control of the business, the franchisee becomes nothing more than an employee of the franchisor with no real independent ownership or independent operation - which is mandated by the statute. Further, this would also mean that the government guarantee of an SBA loan could potentially be used to serve as a corporate subsidy to a much larger entity, which was not the intent of the plain language of the Act.

QUESTION 3:

Why is it important for the SBA to not only continue its evaluation of affiliation in the case of franchise businesses, but also to continue publishing the franchise directory?

As mentioned above, the Small Business Act is clear that its intent is to provide support to independently owned and operated businesses. In the context of franchises, it had been historically difficult for potential franchises and lenders to determine which franchises were not deemed to be affiliated with or controlled by a larger corporation. This led to uncertainty amongst borrowers and lenders, as well as inconsistency in lending decisions. Recognizing this, in 2018, the SBA established something called the Franchise Directory - which was a publicly available list of several thousand franchises which were deemed eligible for SBA loans, confirming that the franchise brands on the list were not deemed to be part of a larger corporate structure under affiliation and control standards. Establishing this list was not without considerable effort from the talented career professionals within SBA's Office of General Counsel and Office of Capital Access in that each franchise agreement was reviewed, relevant contractual clauses were modified, and an SBA-approved addendum to franchise agreements was established to ensure that potential elements of affiliation and control were addressed. In short, if a brand was in the Franchise Directory, the SBA was satisfied that it had met the appropriate standards for an SBA loan. This Franchise Directory was popular as the borrower had certainty that if the particular franchise in scope was on the list, it could be approved by the lender and the lender knew that they could collect on the SBA guarantee if the borrower defaulted.

Under its recent rules, the current Administration has revised the standards around affiliation and control, and has terminated the Franchise Directory. I believe that that action could result in a return to the historical confusion and inconsistency previously referenced. This could lead to less entrepreneurship and less small business lending in this space due to a lack of a clear public database, coupled with a lender concern of not having agency confirmation that the guarantee will be available to them. This could not only impact any positive trends associated with the nearly 800,000 locally owned small franchise businesses, but affect sustainable workforce opportunities – which are estimated to be approximately 8.4 million people and counting.

An additional concern to reference here is that franchise ownership has demonstrated to be a pathway to entrepreneurship for underserved communities as their employees gain direct exposure to the operations of the small business, giving them the experience, familiarity and the confidence to consider their own journey to entrepreneurship by starting a similar franchise. The removal of the Franchise Directory will presumably have the downstream impact on these communities as well.

Question from:

Senator Hickenlooper

Access to Capital

In 2019, more than a quarter of startups named lack of credit as their top business challenge.

QUESTION 1:

How does your organization, and others like it, work to get capital into the hands of startups?

Accion Opportunity Fund (AOF) is a community development financial institution (CDFI) licensed with the State of California's Department of Financial Protection and Innovation (DFPI) and the CDFI Fund at the U.S. Department of Treasury. AOF is one of the nation's leading non-profit CDFIs providing affordable loans, business advising and support networks to underinvested entrepreneurs which have been left behind by our mainstream financial system. To date, AOF has deployed over $700 million to over 25,000 entrepreneurs and 80% of its borrowers are entrepreneurs of color, women and/or low income entrepreneurs. In fact, women make up one out of every three clients we serve.

AOF, as a national lender serving 45 states, does not have the typical "boots on the ground" CDFI model. Instead, we deliver our lending and business advising through tech and touch which means that we leverage technology and data analytics to enable our lending, meeting customers where they are and offering a combination of digital engagement and/or access to speak with a bilingual (English and Spanish) representative seven days/week, 15 hours/day. This model allows us to serve thousands of businesses per year. It also allows us to bring together businesses and experts from different parts of the country, serving as a connector, to expand their networks and learn from each other. To bring hyper-local reach or expertise to our offerings, we often create formal partnerships with local business support organizations, including local CDFIs or business incubators, to develop and execute local programming and learning opportunities for small business owners in a particular market. The key to success is to identify the strengths that each partner can bring to the table and where they complement each other to have a greater impact together. AOF believes that access to small business capital for underserved communities is a bipartisan priority, and we appreciate the Committee's engagement on this important issue.