

FOR RELEASE ON DELIVERY  
EXPECTED AT 9:30 a.m. DST  
TUESDAY, MAY 19, 1981

STATEMENT OF  
HENRY ESCHWEGE, DIRECTOR  
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE  
SUBCOMMITTEE ON COMMERCE, CONSUMER, AND  
MONETARY AFFAIRS  
COMMITTEE ON GOVERNMENT OPERATIONS  
HOUSE OF REPRESENTATIVES

MBE01501

ON [SBA  
? SMALL BUSINESS ADMINISTRATION FRANCHISE LOANS:  
RISK OF LOSS CAN BE REDUCED AND  
PROGRAM EFFECTIVENESS IMPROVED ]

AGC 20002

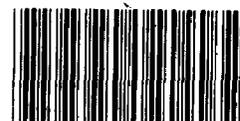
MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

WE ARE HERE TODAY AT THE REQUEST OF THE SUBCOMMITTEE TO  
DISCUSS THE RESULTS OF OUR REVIEW OF SMALL BUSINESS ADMINISTRATION  
(SBA) LOANS TO FRANCHISE BUSINESSES.

IN FEBRUARY 1979 YOU REQUESTED US TO REVIEW SBA FRANCHISE  
LOANS UNDER THE 7(a) BUSINESS LOAN PROGRAM. WE FOCUSED OUR EFFORTS  
ON SEVERAL SPECIFIC QUESTIONS OF PARTICULAR INTEREST TO THE SUB-  
COMMITTEE. AS A RESULT, OUR OBSERVATIONS RELATE PRIMARILY TO THOSE  
QUESTIONS WHICH ARE DISCUSSED IN DETAIL IN OUR REPORT OF APRIL 11,  
1980 (CED-80-47). THE SUBCOMMITTEE RELEASED THE REPORT TO SBA IN  
LATE OCTOBER 1980. OTHER THAN REVIEWING THE AGENCY'S REQUIRED  
RESPONSE DATED JANUARY 6, 1981 WE HAVE NOT FOLLOWED UP ON ITS  
CONTENTS.

BACKGROUND

BRIEFLY, LET ME PROVIDE SOME BACKGROUND INFORMATION ON  
SBA FRANCHISE LOANS. FROM 1959, WHEN THE FIRST LOAN WAS MADE,



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THROUGH APRIL 1979, AN ESTIMATED 16,379 LOANS TOTALING ABOUT \$1 BILLION HAD BEEN MADE TO FRANCHISE BUSINESSES. THE NUMBER AND AMOUNT OF LOANS MADE IS ESTIMATED BECAUSE SOME OF THE SBA DISTRICT OFFICES WE VISITED DID NOT PROPERLY CLASSIFY AND REPORT ALL LOANS MADE TO FRANCHISEES. BASED ON SBA RECORDS, FRANCHISE LOANS TOTALING ABOUT \$27 MILLION HAD BEEN WRITTEN OFF AS UNCOLLECTIBLE AND ABOUT \$65 MILLION WERE BEING LIQUIDATED AS OF APRIL 30, 1979. APPENDIX I ATTACHED TO MY STATEMENT SHOWS THAT FRANCHISEES FROM 25 FRANCHISORS HAD RECEIVED 6,520 LOANS TOTALING \$450 MILLION, OR ALMOST HALF OF THE AMOUNT SBA HAD LOANED OR GUARANTEED. ABOUT 89 PERCENT OF ALL FRANCHISE LOANS WAS MADE UNDER SBA'S 7(a) PROGRAM AND 11 PERCENT UNDER THE ECONOMIC OPPORTUNITY LOAN AND LOCAL DEVELOPMENT COMPANY PROGRAMS.

GUARANTEED LOANS ACCOUNTED FOR ABOUT 83 PERCENT OF THE FRANCHISE LOANS SBA HAD MADE—THE REMAINDER ARE PRIMARILY DIRECT LOANS. GUARANTEED LOANS ARE MADE BY PRIVATE LENDERS WITH SBA GUARANTEEING UP TO 90 PERCENT OF THE LOANS. AT THE TIME OF OUR REVIEW, A MAXIMUM OF \$500,000 COULD BE LOANED TO ONE BORROWER. FRANCHISE LOANS HAVE 10-YEAR MATURITIES; WHEN USED TO ACQUIRE REAL PROPERTY OR TO CONSTRUCT FACILITIES THIS MAY BE 20 YEARS.

#### SCOPE OF REVIEW

WE REVIEWED 92 LOANS IN 10 OF SBA'S FIELD OFFICES. THESE OFFICES WERE PRIMARILY IN THE NORTHEASTERN STATES AND CALIFORNIA. SEVENTY-EIGHT OF THE LOANS WERE GUARANTEED AND 14 WERE DIRECT LOANS. MOST OF THE LOANS WE REVIEWED WERE MADE TO AUTOMOBILE DEALERS, GASOLINE STATIONS, AND FAST FOOD FRANCHISES—THE PRINCIPAL TYPES OF BUSINESSES INVOLVED IN ALL SBA FRANCHISE LOANS. THE

RESULTS OF OUR REVIEW MAY NOT BE REPRESENTATIVE OF ALL FRANCHISE LOANS BECAUSE THE NUMBER OF LOANS REVIEWED WAS TOO SMALL TO ALLOW US TO MAKE OVERALL PROJECTIONS. THE DEFAULT RATES WHICH I'LL MENTION LATER, HOWEVER, WERE BASED ON ALL FRANCHISE LOANS MADE THROUGH APRIL 30, 1979.

SBA TAKES GREATER RISK THAN NECESSARY ON FRANCHISE LOANS

ACCORDING TO 1978 SBA DATA, THE LATEST AVAILABLE AT THE TIME OF OUR REVIEW, SBA'S RISK OF LOSS OR SHARE OF OUTSTANDING FRANCHISE LOAN BALANCES TOTALED ABOUT \$548 MILLION. SBA UNNECESSARILY BEARS MOST OF THE RISK ON THESE LOANS IN PART BECAUSE, IT HAS NOT REQUIRED FRANCHISORS TO SHARE IN GUARANTEEING BANK LOANS, OR TO GUARANTEE SBA DIRECT LOANS MADE TO FRANCHISEES. ALSO, SBA FREQUENTLY GUARANTEES BANK LOANS AT THE MAXIMUM ALLOWABLE LIMIT OF 90 PERCENT AND MAKES LITTLE EFFORT TO GET BANKS TO TAKE ON A GREATER SHARE OF THE RISK. FOR EXAMPLE, \$26.4 MILLION OR ABOUT 94 PERCENT OF ALL SBA GUARANTEED LOANS MADE TO McDONALD'S FRANCHISEES WERE GUARANTEED AT THE MAXIMUM PERCENT, ALTHOUGH ONLY \$120 HAD BEEN CHARGED OFF. SINCE THE RISK OF LOSS ON LOANS TO McDONALD'S FRANCHISEES IS THEREFORE NEGLIGIBLE, SBA SHOULD BE IN A GOOD POSITION TO NEGOTIATE WITH BANKS TO REDUCE SBA'S SHARE OF LOAN GUARANTEES, WHICH WOULD DECREASE SBA'S RISK OF LOSS ON MANY OF THESE LOANS.

MOREOVER, SBA MAY NOT ALWAYS BE FUNCTIONING AS A LENDER OF LAST RESORT AS REQUIRED BY LAW. ITS LOAN FILES OFTEN DID NOT CONTAIN ADEQUATE DOCUMENTATION THAT BANKS AND OTHER POTENTIAL SOURCES OF FUNDS HAD REFUSED TO PROVIDE FINANCING WITHOUT SBA

ASSISTANCE. FURTHERMORE, SBA DOES NOT CONSIDER FRANCHISORS AS A POTENTIAL SOURCE OF LOANS FOR PROSPECTIVE FRANCHISEES AND, AS A RESULT, MAY BE PROVIDING FINANCIAL ASSISTANCE TO BORROWERS THAT COULD OBTAIN SUCH ASSISTANCE FROM NON-FEDERAL SOURCES.

SBA POLICY ALSO DOES NOT REQUIRE THAT FRANCHISORS BE CONSIDERED AS LOAN GUARANTORS WHEN SBA MAKES DIRECT LOANS TO FRANCHISEES. SBA FIELD OFFICE OFFICIALS HAD MIXED REACTIONS TO IMPLEMENTING SUCH A POLICY. SOME SBA OFFICIALS FEARED THAT SUCH A POLICY COULD LEAD TO FRANCHISORS' HAVING TOO MUCH CONTROL OVER THEIR FRANCHISEES, WHILE OTHERS THOUGHT IT TO BE A GOOD IDEA TO AT LEAST REQUEST PARTIAL FUNDING OR A LOAN GUARANTEE FROM FRANCHISORS. WE NOTED ONE LOAN TO A FRANCHISEE WHERE IT WOULD HAVE BEEN PARTICULARLY DESIRABLE TO HAVE A FRANCHISOR GUARANTEE. THE APPROVED SBA LOAN HAD A 10-YEAR MATURITY EVEN THOUGH THE FRANCHISEE BORROWER HAD ONLY A 5-YEAR BUSINESS LEASE. WE DO NOT KNOW HOW WIDESPREAD THIS PRACTICE IS, BUT AN SBA DISTRICT DIRECTOR TOLD US THAT HIS DISTRICT HAD ALSO MADE AT LEAST ONE LOAN UNDER SIMILAR CIRCUMSTANCES. SBA'S OPERATING PROCEDURES DO STATE THAT "NORMALLY, THE LEASE SHOULD RUN AT LEAST THROUGH THE TERM OF THE LOAN."

THE REASON SBA GAVE FOR NOT CONSIDERING FRANCHISORS AS LOAN SOURCES WAS SIMPLY THAT THESE COMPANIES WERE NOT LENDERS OR HAD NO FUNDS TO LEND. ALSO, THE INTERNATIONAL FRANCHISE ASSOCIATION, REPRESENTING ABOUT 380 FRANCHISORS, TOLD US THAT FRANCHISORS DO NOT MAKE LOANS PRIMARILY BECAUSE THEY DO NOT HAVE THE NECESSARY CAPITAL.

USING A QUESTIONNAIRE, WE ASKED 94 MAJOR FRANCHISORS WHY THEY DID NOT MAKE LOANS TO THEIR FRANCHISEES. ONLY 25 OF THE

69 THAT DO NOT MAKE DIRECT LOANS TO THEIR FRANCHISEES SAID THAT LACK OF CAPITAL WAS A PRIMARY REASON FOR NOT MAKING LOANS. FIVE FRANCHISORS SAID THEY DID MAKE DIRECT LOANS TO THEIR FRANCHISEES.

ALSO, WE ASKED THE 94 MAJOR FRANCHISORS, WHAT THEIR REACTIONS WOULD BE IF SBA REQUIRED THAT THEY SHARE BANK LOAN GUARANTEES. NEARLY ALL WHO RESPONDED OPPOSED SUCH A REQUIREMENT. THE REACTION WAS ABOUT THE SAME TO A SUGGESTION THAT THEY GUARANTEE AT LEAST PART OF SBA DIRECT LOANS MADE TO FRANCHISEES. EIGHT OF THE 74 FRANCHISORS RESPONDING HOWEVER, DID ACKNOWLEDGE THAT THEY GUARANTEE BANK LOANS MADE TO NEW FRANCHISEES. THESE FRANCHISORS SAID THAT THEY HAD FULLY GUARANTEED LOANS TO THEIR FRANCHISEES TOTALING ALMOST \$10 MILLION DURING THE 4-YEAR PERIOD ENDING DECEMBER 31, 1978, AND HAD PARTIALLY GUARANTEED ANOTHER \$6.7 MILLION DURING THIS PERIOD. AS TO WHY FRANCHISORS DID NOT GUARANTEE LOANS MADE TO THEIR FRANCHISEES, 46 OF THE 56 THAT RESPONDED TO THIS QUESTION SAID A PRIMARY REASON WAS THAT LOANS WERE AVAILABLE ELSEWHERE WITHOUT SUCH GUARANTEES.

YOUR SUBCOMMITTEE STAFF RECENTLY BROUGHT TO OUR ATTENTION A WASHINGTON, D.C. LENDER WHO SOMETIMES REQUIRES FRANCHISORS TO GUARANTEE PART OF THE LOANS HIS ORGANIZATION MAKES TO FRANCHISEES. THE LENDER STATED THAT THE "TRACK RECORD" OF THE FRANCHISOR DETERMINED THE AMOUNT OF GUARANTEE REQUESTED. AS AN EXAMPLE, THE LENDER SAID THAT EVEN FRANCHISORS WITH A NORMAL "TRACK RECORD" MIGHT BE REQUESTED TO GUARANTEE 5 TO 10 PERCENT OF THE FRANCHISEE'S LOAN.

IN ADDITION, WE REVIEWED INFORMATION YOU RECEIVED FROM SBA'S DETROIT DISTRICT OFFICE WHICH INDICATES THAT THE OFFICE MAY

SOMETIMES REQUIRE THAT THE FRANCHISE AGREEMENT BE MODIFIED TO HELP PROTECT SBA OR THE BANK. FRANCHISORS ARE ASKED TO MAKE CERTAIN CONCESSIONS, SUCH AS TO CONSENT TO THE ASSIGNMENT OF THE FRANCHISE TO SBA OR THE BANK IF THE FRANCHISEE DEFAULTS. IN SUCH CASES, SBA WOULD FIND ANOTHER FRANCHISEE TO ASSUME THE LOAN. McDONALD'S WAS ONE FRANCHISOR THAT AGREED TO THIS MODIFICATION TO ITS FRANCHISE AGREEMENTS. IN OTHER CASES IN WHICH THE FRANCHISEE CANNOT MAKE LOAN PAYMENTS, A DETROIT DISTRICT OFFICE OFFICIAL TOLD US THAT THE OFFICE SOMETIMES REQUESTS THAT ROYALTY AND OTHER PAYMENTS MADE BY THE FRANCHISEE TO THE FRANCHISOR BE DEFERRED UNTIL THE LOAN IS MADE CURRENT.

THESE PRACTICES MAY BE WAYS OF GETTING FRANCHISORS TO TAKE GREATER INTEREST IN THE SUCCESS OF FRANCHISEES. THE FRANCHISOR BENEFITS FROM THE SUCCESS OF THE FRANCHISEE THROUGH CONTINUED PRODUCT SALES AND COLLECTION OF FRANCHISE FEES AND ROYALTIES. YET, THE FRANCHISORS MAY OFTEN SUFFER ONLY MINIMAL LOSS, OTHER THAN PERHAPS A TEMPORARY REDUCTION IN INCOME, FROM THE FINANCIAL FAILURE OF A FRANCHISEE, AS THE FRANCHISOR WOULD LIKELY FIND ANOTHER FRANCHISEE.

FRANCHISORS WOULD HAVE MORE INCENTIVE TO ASSURE THE FINANCIAL SUCCESS OF SBA FRANCHISEE BORROWERS IF THEY WERE REQUIRED TO SHARE THE BURDEN OF LOSS WITH SBA. ALSO, SBA COULD POSSIBLY REDUCE ITS LOAN VOLUME AND ENSURE THAT IT WAS NOT PROVIDING FINANCIAL ASSISTANCE TO BORROWERS ABLE TO OBTAIN SUCH ASSISTANCE FROM NON-FEDERAL SOURCES, AS THE LAW REQUIRES. WE HAVE IN MIND HERE THAT SBA MIGHT REQUIRE PROSPECTIVE FRANCHISEE BORROWERS TO SEEK LOANS

FROM FRANCHISORS OR SUBSIDIARY CREDIT CORPORATIONS OF FRANCHISORS  
BEFORE BECOMING ELIGIBLE FOR SBA LOANS.

LOAN APPROVAL PRACTICES  
NEED TO BE IMPROVED

GENERALLY, WE FOUND THAT SBA PROCEDURES AND REGULATIONS FOR MAKING FRANCHISE LOANS WERE ADEQUATE TO ENSURE REASONABLE LOAN REPAYMENT. HOWEVER, SBA DID NOT COMPLY FULLY WITH ITS PROCEDURES AND FEDERAL REGULATIONS; THIS MAY HAVE CONTRIBUTED TO THE NUMBER OF LOANS THAT DEFAULTED AND HAD TO BE WRITTEN OFF. SBA'S PRACTICES ALSO WERE NOT ADEQUATE TO ENSURE ELIGIBILITY FOR LOANS OR LOAN REPAYMENT ABILITY OF FRANCHISEES, THEREBY INCREASING SBA'S RISK OF LOSS.

LET ME CITE A FEW EXAMPLES OF DISTRICT OFFICE NONCOMPLIANCE WITH SBA PROCEDURES.

- ONLY 7 OF 92 LOAN FILES REVIEWED CONTAINED PROOF OF BANK OR OTHER POTENTIAL LENDERS REFUSAL TO MAKE THE LOANS, AS REQUIRED BY FEDERAL REGULATIONS.
- TWENTY-SIX LOAN FILES DID NOT CONTAIN CREDIT REPORTS ON THE BORROWERS.
- SIXTY-TWO OF THE 92 FILES DID NOT CONTAIN FRANCHISE AGREEMENTS.

LET ME ADDRESS SOME AREAS OF PARTICULAR CONCERN IN MORE DETAIL.

FRANCHISE AGREEMENTS AND  
CREDIT REPORTS NOT OBTAINED

FRANCHISE AGREEMENTS ARE NEEDED TO REVIEW THE CONTRACTUAL TERMS AND FINANCIAL REQUIREMENTS LEVIED ON BORROWERS. WITHOUT THESE AGREEMENTS, SBA DOES NOT KNOW WHETHER THE BORROWER IS

ELIGIBLE FOR A LOAN. FOR EXAMPLE, SBA CANNOT DETERMINE THE EXTENT OF THE BORROWER'S AFFILIATION WITH THE FRANCHISOR, THE BORROWER'S RIGHT TO PROFIT OR LOSS COMMENSURATE WITH OWNERSHIP, OR WHETHER PROVISIONS IN THE AGREEMENT AFFECT THE BORROWER'S LOAN REPAYMENT ABILITY. DESPITE THEIR IMPORTANCE, ONLY 30 OF THE 92 LOAN FILES WE REVIEWED CONTAINED FRANCHISE AGREEMENTS. FAILURE TO REVIEW THESE AGREEMENTS COULD HAVE HAD AN ADVERSE IMPACT ON THE BUSINESSES THAT FAILED. FOR EXAMPLE, 5 OF 11 FRANCHISE OWNERS INTERVIEWED IN ONE AREA WE VISITED BELIEVED THAT THE AGREEMENTS HAD HINDERED THEIR ABILITY TO REPAY SBA LOANS, AND 4 OF THE 5 SAID THE AGREEMENTS WERE TOO RESTRICTIVE AS TO PRICES THEY COULD CHARGE.

THE SBA DETROIT DISTRICT OFFICE SEEMS TO RECOGNIZE THE IMPORTANCE OF REVIEWING THESE AGREEMENTS. IN A LETTER TO THE SBA CENTRAL OFFICE, THE DISTRICT DIRECTOR SAID THAT ONE WOULD EXPECT THAT THE TERMS AND CONDITIONS OF THE BASIC FRANCHISE AGREEMENT WOULD BE THOROUGHLY EVALUATED AND WOULD BE A MATERIAL FACTOR IN THE FINAL CREDIT DECISION. HE SAID HE WAS SURPRISED TO LEARN THAT IT WAS NOT COMMON PRACTICE IN HIS OFFICE TO EVALUATE THE ACTUAL TERMS AND CONDITIONS OF FRANCHISE AGREEMENTS AS PART OF THE CREDIT EVALUATION PROCESS. HE SAID THAT, WHEN MAKING CREDIT EVALUATIONS, MODIFICATIONS ARE OFTEN REQUIRED TO THE PROPOSED FRANCHISE AGREEMENT BETWEEN THE FRANCHISOR AND FRANCHISEE TO PROPERLY PROTECT THE COLLATERAL POSITION OF SBA AND MINIMIZE SBA'S RISK OF LOSS. THE DISTRICT DIRECTOR POINTED OUT THAT

"SOME OF THE TERMS AND CONDITIONS WE RUN ACROSS ARE SO ONE-SIDED AND UNREASONABLE AS TO BE UNCONSCIONABLE AND TOTALLY UNACCEPTABLE TO ANY RESPONSIBLE LENDER."

AS FOR CREDIT REPORTS, 26 OF THE 92 LOAN FILES WE REVIEWED DID NOT CONTAIN REPORTS ON THE BORROWERS AND ONLY TWO FILES CONTAINED REPORTS ON FRANCHISORS. WITHOUT THESE REPORTS SBA MAY NOT BE ABLE TO DETERMINE THE BORROWERS' OR FRANCHISORS' CREDIT STANDING, THEREBY INCREASING SBA'S RISK OF LOSS.

SBA DOES NOT REQUIRE  
MARKETING STUDIES

SBA'S PROCEDURES GIVE DISTRICT OFFICES DISCRETION IN DETERMINING WHETHER TO OBTAIN MARKETING STUDIES AND OTHER ECONOMIC STUDIES. THESE STUDIES HELP TO DETERMINE WHETHER A GIVEN AREA OR MARKET WILL SUPPORT A BUSINESS. NINE OF THE TEN DISTRICTS WE VISITED DID NOT REQUIRE THESE STUDIES BEFORE APPROVING LOANS. WITHOUT SUCH STUDIES, SBA'S RISK OF LOSS IS LIKELY TO INCREASE. SEVERAL FORMER FRANCHISEES TOLD US THAT POOR LOCATION SELECTED BY FRANCHISORS WAS A MAJOR REASON THEIR BUSINESSES FAILED.

DEFINITION OF A FRANCHISE  
AND MORE INFORMATION NEEDED

SBA HAS NOT ACCUMULATED DATA ON FRANCHISE LOAN FAILURES OR ON THE REASONS FOR LOAN FAILURES. AS A RESULT, BOTH THE SBA DISTRICT OFFICES AND PROSPECTIVE FRANCHISEE BORROWERS ARE DEPRIVED OF THIS IMPORTANT INFORMATION WHICH COULD HELP THEM MAKE BETTER LOAN DECISIONS. IN OUR OPINION, SBA'S ACCUMULATION AND DISSEMINATION OF FRANCHISE DEFAULT RATES COULD REDUCE THE POTENTIAL FOR LOAN DEFAULTS. NOT ONLY COULD SUCH INFORMATION DETER SOME FRANCHISEE LOAN APPLICANTS FROM ENTERING INTO POTENTIALLY RISKY

BUSINESS VENTURES, BUT IT COULD ALSO HELP SBA DETERMINE WHICH LOAN APPLICATIONS WARRANT CLOSER SCRUTINY.

ALSO, ALTHOUGH SBA HAS MADE FRANCHISE LOANS SINCE 1959, IT DOES NOT HAVE AN OFFICIAL DEFINITION OF A FRANCHISE. NUMERICAL CODES TO IDENTIFY FRANCHISORS AND TO CLASSIFY LOANS MADE TO FRANCHISEES HAVE BEEN ESTABLISHED. SBA DISTRICT OFFICES, HOWEVER, INDEPENDENTLY DETERMINE WHICH LOAN APPLICANTS WILL BE CLASSIFIED AS FRANCHISEES.

OUR WORK DISCLOSED THAT LOANS TO FRANCHISEES WERE BEING ACCOUNTED FOR UNDER TWO OR THREE FRANCHISOR NAMES EVEN THOUGH ONLY ONE FRANCHISOR WAS INVOLVED. ALSO, MANY NON-FRANCHISE LOANS WERE ERRONEOUSLY CLASSIFIED AS FRANCHISE LOANS. SIX OF THE SBA DISTRICT OFFICES VISITED CLASSIFIED LOANS TO GASOLINE STATIONS AS FRANCHISES WHILE THE OTHER FOUR DID NOT. TWO OF THE OFFICES VISITED DID NOT CLASSIFY LOANS MADE TO AUTOMOBILE DEALERS AS FRANCHISE LOANS, WHILE THE OTHERS DID. BY NOT PROPERLY AND UNIFORMLY CLASSIFYING FRANCHISE LOANS, SBA CANNOT ACCURATELY REPORT THE NUMBER OF LOANS MADE OR COMPUTE LOAN FAILURE RATES BY FRANCHISOR.

OUR CURRENT ANALYSIS OF THE 16,379 SBA LOANS MADE TO FRANCHISEES THROUGH APRIL 1979 SHOWED THAT THE DEFAULT RATES FOR SEVERAL MAJOR 1/ FRANCHISORS WERE HIGH. FOR EXAMPLE, OVER 30 PERCENT OF THE LOANS MADE TO THE FRANCHISEES OF THREE FRANCHISORS HAD DEFAULTED. (FRANCHISEES OF ONE OF THE FRANCHISORS HAD RECEIVED 107 LOANS, THOSE OF ANOTHER FRANCHISOR HAD RECEIVED 36 LOANS, AND

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1/Defined as receiving over 30 loans or over \$1 million of SBA loans as of April 30, 1979.

15 LOANS WERE MADE TO FRANCHISEES OF THE OTHER FRANCHISOR.) ALSO, FROM 15 TO 25 PERCENT OF THE LOANS TO FRANCHISEES FOR 21 OTHER FRANCHISORS HAD DEFAULTED. APPENDIX II ATTACHED TO MY STATEMENT CONTAINS A LISTING OF THE 30 MAJOR FRANCHISORS WHOSE FRANCHISEES HAD THE HIGHEST SBA LOAN DEFAULT RATES AS OF APRIL 30, 1979. THIS LISTING MAY NOT INCLUDE ALL LOANS BECAUSE OF SBA'S PROBLEM IN CODING THE LOANS, AS PREVIOUSLY MENTIONED.

IN ADDITION, OUR ANALYSIS OF FRANCHISE LOANS SHOWED THAT THE DEFAULT RATES FOR MANY NON-MAJOR 1/ FRANCHISORS WERE VERY HIGH. FOR EXAMPLE, THESE RATES RANGED FROM 35 TO 100 PERCENT; THE NUMBER OF LOANS RANGED FROM 5 TO 26. APPENDIX III ATTACHED TO MY STATEMENT CONTAINS A LISTING OF THE TOP 30 NON-MAJOR FRANCHISORS WHOSE FRANCHISEES HAD THE HIGHEST SBA DEFAULT RATES AS OF APRIL 30, 1979.

SBA HEADQUARTERS OFFICIALS AGREED THAT AN ANALYSIS OF SBA FRANCHISE LOANS WOULD BE USEFUL TO THEIR LOAN OFFICERS FOR REVIEWING AND EVALUATING FRANCHISE LOAN APPLICATIONS. THESE OFFICIALS DID NOT AGREE, HOWEVER, THAT FRANCHISOR LOAN DEFAULT RATES SHOULD BE PROVIDED TO PROSPECTIVE SBA BORROWERS BECAUSE OF FEAR OF LAWSUITS. WE BELIEVE THAT SBA HAS AN OBLIGATION TO PROVIDE THIS INFORMATION TO PROSPECTIVE FRANCHISEES UNDER ITS LEGAL MANDATE TO AID, COUNSEL, AND ASSIST BORROWERS.

ANOTHER SOURCE OF INFORMATION ON FRANCHISORS IS NOW AVAILABLE AS A RESULT OF A FEDERAL TRADE COMMISSION RULE WHICH

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1/Franchisors with 5 or more but less than 30 loans and less than \$1 million of loans received.

WENT INTO EFFECT ON OCTOBER 21, 1979. THIS RULE REQUIRES FRANCHISORS TO PROVIDE PROSPECTIVE FRANCHISEES WITH A DISCLOSURE STATEMENT CONTAINING INFORMATION ON FRANCHISORS AND THEIR FRANCHISEES, INCLUDING BANKRUPTCY HISTORY, FRANCHISE COSTS, RESTRICTIONS ON FRANCHISES, TERMINATIONS AND CANCELLATIONS, AND FRANCHISOR FINANCIAL DATA. SBA ADVISED ITS DISTRICT OFFICES TO OBTAIN THIS DISCLOSURE STATEMENT FROM FRANCHISEE BORROWERS FOR USE IN MAKING LOAN DECISIONS. HOWEVER, SBA INFORMATION RECENTLY PROVIDED TO YOUR SUBCOMMITTEE STAFF SHOWS THAT AS OF JULY 1, 1980, SBA'S DISTRICT OFFICES HAD OBTAINED THIS IMPORTANT INFORMATION FOR ONLY 11 PERCENT OF THE FRANCHISE LOANS MADE. THE FEDERAL TRADE COMMISSION STATED IN A LETTER TO YOUR STAFF THAT FAILURE TO OBTAIN AND REVIEW A FRANCHISE DISCLOSURE STATEMENT COULD "SERIOUSLY JEOPARDIZE" THE POTENTIAL SUCCESS OF THE PROPOSED FRANCHISE AND THE FRANCHISEE'S ABILITY TO REPAY AN SBA LOAN.

MR. CHAIRMAN, WE MADE SEVERAL RECOMMENDATIONS TO THE ADMINISTRATOR IN OUR REPORT FOR IMPROVING SBA FRANCHISE LOAN PRACTICES. FOR EXAMPLE, WE RECOMMENDED THAT:

1. SBA SHOULD NOT MAKE OR GUARANTEE FRANCHISE LOANS UNLESS IT HAS EVIDENCE THAT THE FRANCHISOR CANNOT GUARANTEE ALL OR PART OF SBA DIRECT LOANS OR SHARE WITH SBA IN GUARANTEES OF BANK LOANS.
2. SBA SHOULD NOT MAKE OR GUARANTEE FRANCHISE LOANS IF THE FRANCHISOR CAN PROVIDE FINANCIAL ASSISTANCE ON REASONABLE TERMS.

3. DISTRICT OFFICES SHOULD OBTAIN AND REVIEW FRANCHISE AGREEMENTS IN ALL CASES TO ENSURE THAT PROVISIONS IN THE AGREEMENTS DO NOT MAKE PROSPECTIVE BORROWERS INELIGIBLE FOR LOANS OR UNDULY RESTRICT THE BORROWERS' REPAYMENT ABILITIES.
4. THE HEADQUARTERS OFFICE SHOULD ESTABLISH AN INFORMATION FILE ON FRANCHISE LOANS, INCLUDING LOAN FAILURE RATES FOR EACH FRANCHISOR AND THE REASONS FOR EACH FAILURE. WE STATED THAT THIS INFORMATION SHOULD BE DISSEMINATED TO DISTRICT OFFICES AND PROSPECTIVE FRANCHISE LOAN APPLICANTS FOR THEIR USE IN MAKING LOAN DECISIONS AND IN HELPING TO REDUCE THE POTENTIAL FOR LOSSES ON LOANS.

A LISTING OF ALL OUR RECOMMENDATIONS IS INCLUDED AS APPENDIX IV TO MY STATEMENT.

SBA DISAGREED WITH MANY OF OUR RECOMMENDATIONS. SBA BELIEVES THAT (1) FRANCHISORS WOULD NOT AGREE WITH OUR PROPOSED ACTIONS BECAUSE THEY WOULD TEND TO DECREASE THE NUMBER OF FRANCHISE LOANS SBA MAKES, (2) FRANCHISE AGREEMENTS WERE BEING REVIEWED AS REQUIRED, AND (3) VERY DIFFICULT PUBLIC RELATIONS PROBLEMS WOULD BE CREATED AND PUBLIC LAWSUITS WOULD PROLIFERATE IF FRANCHISE FAILURE RATES WERE PROVIDED TO PROSPECTIVE BORROWERS. WE EVALUATED SBA'S COMMENTS AND OUR REPORT PROVIDES THE RATIONALE FOR OUR CONTINUED BELIEF THAT OUR RECOMMENDATIONS ARE VALID.

THIS CONCLUDES OUR PREPARED STATEMENT, MR. CHAIRMAN. WE WILL BE PLEASED TO RESPOND TO YOUR QUESTIONS.

Top 25 Franchisors According to the Number  
of SBA Loans Their Franchisees Had  
Received as of April 30, 1979

|                                     | <u>Number of<br/>loans</u> | <u>Amount disbursed<br/>(millions)</u> |
|-------------------------------------|----------------------------|--|
| General Motors Corp.                | 792                        | \$78.2                                 |
| Ford Motor Co.                      | 662                        | 56.3                                   |
| Western Auto                        | 395                        | 14.8                                   |
| Chrysler Motor Corp.                | 384                        | 27.7                                   |
| Standard Oil                        | 325                        | 16.6                                   |
| Coast to Coast Stores               | 322                        | 16.7                                   |
| Ben Franklin Stores                 | 279                        | 22.3                                   |
| Kampgrounds of America              | 270                        | 20.3                                   |
| Gamble's Stores                     | 270                        | 11.2                                   |
| Dairy Queen                         | 256                        | 13.5                                   |
| Masco                               | 255                        | 10.0                                   |
| Deere and Company                   | 240                        | 23.8                                   |
| McDonald's Corporation              | 225                        | 29.6                                   |
| International Harvester<br>Company  | 219                        | 22.2                                   |
| Texaco, Inc.                        | 202                        | 6.9                                    |
| Baskin-Robbins                      | 192                        | 6.5                                    |
| A & W International                 | 190                        | 15.7                                   |
| Aamco Transmissions                 | 146                        | 4.9                                    |
| Independent Groceries<br>of America | 145                        | 11.9                                   |
| Mobil Oil                           | 140                        | 3.5                                    |
| True Value Hardware                 | 135                        | 11.6                                   |
| Jack and Jill (Nash-Finch)          | 130                        | 7.7                                    |
| White Auto Stores, Inc.             | 120                        | 3.8                                    |
| Radio Shack Corp.                   | 115                        | 3.2                                    |
| Super Valu Stores                   | <u>111</u>                 | <u>10.9</u>                            |
| Total                               | <u>6,520</u>               | <u>\$449.8</u>                         |

LISTING OF THE 30 MAJOR (NOTE A) FRANCHISORS WHOSE FRANCHISEESHAD THE HIGHEST SBA LOAN DEFAULT (NOTE B) RATESBASED ON SBA RECORDS AS OF APRIL 30, 1979

| <u>Franchisor</u>                    | <u>Number of loans received</u> | <u>Number of loans defaulted</u> | <u>Loan default rate (percent)</u> | <u>Amount of loans received</u> | <u>Amount of loans defaulted</u> | <u>Percentage of loan funds defaulted</u> |
|--------------------------------------|---------------------------------|----------------------------------|------------------------------------|---------------------------------|----------------------------------|---|
| Opportunity Stores                   | 15                              | 5                                | 33.3                               | \$1,158,650                     | \$ 297,506                       | 25.7                                      |
| ARCO Petroleum Products Company      | 36                              | 12                               | 33.3                               | 686,800                         | 104,465                          | 15.2                                      |
| Shell Oil Company                    | 107                             | 34                               | 31.8                               | 2,981,308                       | 346,735                          | 11.6                                      |
| Pappy Enterprises                    | 12                              | 3                                | 25.0                               | 1,061,500                       | 417,303                          | 39.3                                      |
| Lafayette Radio Electronics Corp.    | 53                              | 12                               | 22.6                               | 1,531,801                       | 274,068                          | 17.9                                      |
| Gulf Oil Corporation                 | 73                              | 15                               | 20.5                               | 2,385,000                       | 100,782                          | 4.2                                       |
| Milax, Inc.                          | 31                              | 6                                | 19.4                               | 690,371                         | 137,989                          | 20.0                                      |
| Texaco, Inc.                         | 202                             | 39                               | 19.3                               | 6,859,268                       | 251,724                          | 3.7                                       |
| American Motors Corporation          | 102                             | 19                               | 18.6                               | 6,817,677                       | 393,160                          | 5.8                                       |
| Sun Oil Company, Inc.                | 98                              | 18                               | 18.4                               | 3,962,500                       | 103,980                          | 2.6                                       |
| Chevron                              | 17                              | 3                                | 17.6                               | 1,258,727                       | 29,970                           | 2.4                                       |
| Subaru of America, Inc.              | 17                              | 3                                | 17.6                               | 1,088,147                       | 131,881                          | 12.1                                      |
| Kawasaki Motors Corp. U.S.A.         | 40                              | 7                                | 17.5                               | 1,787,250                       | 167,350                          | 9.8                                       |
| Exxon Company, U.S.A. (note c)       | 94                              | 16                               | 17.0                               | 3,178,100                       | 165,909                          | 5.2                                       |
| Union Oil Company of California      | 48                              | 8                                | 16.7                               | 2,517,900                       | 172,207                          | 6.8                                       |
| Sheraton Inns, Inc.                  | 6                               | 1                                | 16.7                               | 1,997,900                       | 2,754                            | 0.1                                       |
| Royal Crown Bottling Company         | 12                              | 2                                | 16.7                               | 2,472,700                       | 165,183                          | 6.7                                       |
| Mobil Oil Corporation                | 140                             | 23                               | 16.4                               | 3,455,658                       | 163,403                          | 4.7                                       |
| Phillips Petroleum Company           | 98                              | 16                               | 16.3                               | 3,449,300                       | 152,037                          | 4.4                                       |
| Harley Davidson Motor Co., Inc.      | 31                              | 5                                | 16.1                               | 1,194,303                       | 150,582                          | 12.6                                      |
| Ramada Inns, Inc. (note d)           | 31                              | 5                                | 16.1                               | 8,282,500                       | 1,310,956                        | 16.0                                      |
| U.S. Suzuki Motor Corporation        | 50                              | 8                                | 16.0                               | 1,526,800                       | 171,329                          | 11.2                                      |
| Food Land, Inc.                      | 19                              | 3                                | 15.8                               | 2,830,800                       | 196,746                          | 7.0                                       |
| Dog 'N Suds, Inc.                    | 20                              | 3                                | 15.0                               | 1,211,600                       | 195,243                          | 16.1                                      |
| Bresler's 33 Flavors, Inc.           | 41                              | 6                                | 14.6                               | 803,070                         | 56,906                           | 7.1                                       |
| Tastee Freez International, Inc.     | 70                              | 10                               | 14.3                               | 2,874,500                       | 179,756                          | 6.3                                       |
| Mazda Motors of America              | 14                              | 2                                | 14.3                               | 2,050,865                       | 291,686                          | 14.2                                      |
| Zip's International, Inc. (note e)   | 50                              | 7                                | 14.0                               | 1,615,989                       | 225,753                          | 14.0                                      |
| Stretch and Sew, Inc.                | 37                              | 5                                | 13.5                               | 857,077                         | 61,717                           | 7.2                                       |
| Mercedes-Benz of North America, Inc. | 17                              | 2                                | 11.8                               | 2,638,200                       | 435,270                          | 16.5                                      |

a/Defined as those receiving over 30 loans or over \$1 million of SBA loans, as of April 30, 1979.

b/Default, as used here, includes only the loans that were in liquidation or had been charged off as of April 30, 1979.

c/Includes loans made to the Humble Oil and Refining Company now known as Exxon, U.S.A.

d/Includes Ramada Camp-Inn.

e/Includes loans made to Zips Ice Cream, Zips International, and Ice Queen International.

LISTING OF THE 30 NON-MAJOR (NOTE A) FRANCHISORS WHOSE FRANCHISEESHAD THE HIGHEST SBA LOAN DEFAULT (NOTE B) RATESBASED ON SBA RECORDS AS OF APRIL 30, 1979

| <u>Franchisor<br/>(note c)</u> | <u>Number<br/>of loans<br/>received</u> | <u>Number<br/>of loans<br/>defaulted</u> | <u>Loan<br/>default<br/>rate<br/>(percent)</u> | <u>Amount<br/>of loans<br/>received</u> | <u>Amount<br/>of loans<br/>defaulted</u> | <u>Percentage<br/>of loan funds<br/>defaulted</u> |
|--------------------------------|---|--|--|---|--|---|
| Turf Tenders, Inc.             | 5                                       | 5  | 100.0  | \$188,000                               | \$119,770                                | 63.7  |
| Crazy Horse Campground         | 5                                       | 4  | 80.0   | 438,400                                 | 217,369                                  | 49.6  |
| Husk Puppies Inc.              | 5                                       | 4  | 80.0   | 47,200                                  | 36,855                                   | 78.1  |
| Chicken Delight Inc.           | 8                                       | 6  | 75.0   | 102,100                                 | 69,811                                   | 68.4  |
| Mister Softee Inc.             | 6                                       | 4  | 66.7   | 130,907                                 | 97,682                                   | 74.6  |
| American Speed Center          | 19                                      | 12                                       | 63.2   | 265,200                                 | 143,778                                  | 54.2  |
| Speed Equipment World          | 13                                      | 8  | 61.5   | 252,700                                 | 124,580                                  | 49.3  |
| All Pro Chicken Inc.           | 10                                      | 6  | 60.0   | 700,700                                 | 341,825                                  | 48.8  |
| St. George & the Dragon        | 5                                       | 3  | 60.0   | 582,000                                 | 222,940                                  | 38.3  |
| One Hour Valet                 | 5                                       | 3  | 60.0   | 211,000                                 | 134,800                                  | 63.9  |
| Car Matic System               | 5                                       | 3  | 60.0   | 87,500                                  | 47,823                                   | 54.7  |
| Davis Paint Company            | 13                                      | 7  | 53.8   | 157,640                                 | 80,916                                   | 51.3  |
| Half Price Stores              | 12                                      | 6  | 50.0   | 285,500                                 | 69,104                                   | 24.2  |
| Duraclean International        | 26                                      | 13                                       | 50.0   | 197,115                                 | 61,326                                   | 31.1  |
| Cotter and Company             | 6                                       | 3  | 50.0   | 162,500                                 | 98,660                                   | 60.7  |
| Chicken Unlimited Enterprises  | 13                                      | 6  | 46.2   | 444,418                                 | 247,568                                  | 55.7  |
| Aero Mayflower Transit Company | 24                                      | 11                                       | 45.8   | 496,801                                 | 151,836                                  | 30.6  |
| National Speed Center          | 20                                      | 9  | 45.0   | 258,200                                 | 76,817                                   | 29.8  |
| Saxs Steak Sandwich            | 9                                       | 4  | 44.4   | 245,500                                 | 98,028                                   | 39.9  |
| Citgo                          | 14                                      | 6  | 42.9   | 381,200                                 | 40,725                                   | 10.7  |
| Success Motivation Ins.        | 7                                       | 3  | 42.9   | 76,500                                  | 37,836                                   | 49.5  |
| Kingston Laura                 | 10                                      | 4  | 40.0   | 276,500                                 | 62,391                                   | 22.6  |
| Dari Delite Inc.               | 5                                       | 2  | 40.0   | 139,000                                 | 47,986                                   | 34.5  |
| Save Way Barber & Beauty Shop  | 5                                       | 2  | 40.0   | 131,500                                 | 21,497                                   | 16.3  |
| Mr. Swiss of America Inc.      | 5                                       | 2  | 40.0   | 112,750                                 | 31,818                                   | 28.2  |
| Compact Industries             | 5                                       | 2  | 40.0   | 29,064                                  | 6,983                                    | 24.0  |
| Henry's Drive In Inc.          | 8                                       | 3  | 37.5   | 262,000                                 | 66,838                                   | 25.5  |
| BP Oil Corporation             | 11                                      | 4  | 36.4   | 390,795                                 | 14,342                                   | 3.7   |
| El Taco Inc.                   | 14                                      | 5  | 35.7   | 406,825                                 | 97,949                                   | 24.1  |
| Diamond Cab                    | 14                                      | 5  | 35.7   | 197,600                                 | 43,177                                   | 21.9  |

a/ Franchisors with 5 or more but less than 30 loans and less than \$1 million of loans received.

b/ Default as used here includes only the loans that were in liquidation or had been charged off as of April 30, 1979.

c/ Franchisor names taken from SBA's listing of Franchisor Codes, Appendix 11, S.O.P. Section 20 No. 20 Rev. 1R.

RECOMMENDATIONS

To reduce SBA's risk of loss on direct loans to franchisees, as well as SBA-guaranteed bank loans, the Administrator, SBA, should require:

- That SBA not make or guarantee franchise loans unless it has evidence that the franchisor cannot guarantee all or part of SBA direct loans or share the SBA guarantees of bank loans made to franchisees. In carrying out this recommendation, SBA may wish to consider limiting franchisor participation to 3 years--the time within which most small businesses that receive SBA-guaranteed loans fail, according to SBA statistics. We believe that franchisors would be more receptive to this idea if their participation is limited to a short period, rather than the life of the loan.
- District offices to limit, to the maximum extent possible, accepting the weaker types of collateral to secure loans, especially inventory and accounts receivable.
- That district offices have independent appraisals made of collateral pledged for those loans exceeding a certain amount--for example, \$150,000.
- That district offices, using SBA loan history data, negotiate guarantee rates with banks to reduce the number of loans being guaranteed at the maximum 90-percent rate.

To improve SBA franchise loan practices, GAO recommends that the Administrator, SBA:

- Require district offices to obtain for all loans proof of bank refusal to make loans to franchisees, including the date, amount and terms requested, and the reason for refusal, as required by Federal regulations. Alternative methods of obtaining this information might be to (1) revise the loan application to include it as part of the required information thereon or (2) develop a new, short form to be submitted with the loan application.
- Revise SBA regulations to require that SBA not make or guarantee franchise loans if the franchisor can provide assistance to franchisees on reasonable terms.

- Require that the headquarters office make financial analyses of franchisors, particularly those whose franchisees have received over 100 loans, and advise the district offices of the results for their use in obtaining franchisor guarantees of SBA direct loans and sharing of bank-loan guarantees with SBA. Also, these analyses will help ensure that loans are not made to franchisees whose franchisors are not financially sound.
- Emphasize that district offices make or otherwise obtain credit analyses of all franchisees, as the Standard Operating Procedures require.
- Require district offices to obtain and review franchise agreements in all cases to ensure that provisions in the agreements do not make prospective franchisees ineligible for loans or unduly restrict their repayment abilities.
- Revise SBA Standard Operating Procedures to define a franchise so that (1) inconsistencies existing in the district offices in reporting franchise loans will be eliminated, (2) loan officers will not be deprived of information which could result in better loan decisions and reduced risk of loss, and (3) chances of improper review and analysis of loan applications will be reduced.

GAO also recommended that the Administrator, SBA, establish at the headquarters office an information file on franchise loans, including loan failure rates for each franchisor and the reasons for each failure, to (1) be disseminated to district offices and prospective franchisee loan applicants for their use in making loan decisions and (2) help reduce the potential for loan losses.