



June 2018

SMALL BUSINESS LOANS

Additional Actions Needed to Improve Compliance with the Credit Elsewhere Requirement

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Why GAO Did This Study

SBA's 7(a) program is required to serve creditworthy small business borrowers who cannot obtain credit through a conventional lender at reasonable terms. The Joint Explanatory Statement of the Consolidated Appropriations Act, 2017 includes a provision for GAO to review the 7(a) program.

This report discusses, among other things, (1) how SBA monitors lenders' compliance with the credit elsewhere requirement, (2) the extent to which SBA evaluates trends in lender credit elsewhere practices, and (3) lenders' views on the credit elsewhere criteria for 7(a) loans.

GAO analyzed SBA data on 7(a) loans approved for fiscal years 2007–2016, the latest available, and reviewed literature on small business lending; reviewed standard operating procedures, other guidance, and findings from SBA reviews performed in fiscal year 2016; and interviewed lender associations and a nonrepresentative sample of 7(a) lenders selected that concentrated on larger lenders.

What GAO Recommends

GAO recommends that SBA (1) require its on-site reviewers to document their assessment of lenders' policies and procedures related to the credit elsewhere documentation requirement, (2) collect information on lenders' use of credit elsewhere criteria, and (3) analyze that information to identify trends. SBA generally agreed with the recommendations.

View GAO-18-421. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

For its 7(a) loan program, the Small Business Administration (SBA) has largely delegated authority to lenders to make 7(a) loan determinations for those borrowers who cannot obtain conventional credit at reasonable terms elsewhere. To monitor lender compliance with the "credit elsewhere" requirement SBA primarily uses on-site reviews conducted by third-party contractors with SBA participation and oversight, and other reviews. According to SBA guidance, lenders making 7(a) loans must take steps to ensure and document that borrowers meet the program's credit elsewhere requirement. However, GAO noted a number of concerns with SBA's monitoring efforts. Specifically, GAO found the following:

- Over 40 percent (17 of 40) of the on-site lender reviews performed in fiscal year 2016 identified lender noncompliance with the requirement.
- On-site reviewers identified several factors, such as weakness in lenders' internal control processes that were the cause for lender noncompliance.
- Most on-site reviewers did not document their assessment of lenders' policies or procedures, because SBA does not require them to do so. As a result SBA does not have information that could help explain the high noncompliance rate.

Federal internal control standards state that management should design control activities, including appropriate documentation, and use quality information to achieve the entity's objectives. Without better information on lenders' procedures for complying with the documentation requirement, SBA may be limited in its ability to promote compliance with requirements designed to help ensure that the 7(a) program reaches its target population.

SBA does not routinely collect or analyze information on the criteria used by lenders for credit elsewhere justifications. SBA recently began collecting some information on lenders' use of the criteria, but this information is limited, and SBA does not analyze the information that it does collect to better understand lenders' practices. Federal internal control standards state that management should use quality information to achieve the entity's objectives. Without more robust information and analysis, SBA may be limited in its ability to understand how lenders are using the credit elsewhere criteria and identify patterns of use by certain lenders that place them at a higher risk of not reaching borrowers who cannot obtain credit from other sources at reasonable terms.

In general, representatives from 8 of 11 lenders that GAO interviewed stated that SBA's credit elsewhere criteria are adequate for determining small business eligibility for the 7(a) program. These criteria help them target their lending to small businesses that would otherwise have difficulty obtaining conventional credit because they are often new businesses or have a shortage of collateral. However, they also said that other factors—such as lender policies and economic conditions—can affect their decisions to offer 7(a) loans. In January 2018, SBA issued revised guidance for the 7(a) program and has provided training on this new guidance to lenders and trade associations. Lenders told GAO they are still in the process of understanding the new requirements.

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Abbreviations

NAICS	North American Industry Classification System
SBA	Small Business Administration

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U.S. GOVERNMENT ACCOUNTABILITY OFFICE

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June 5, 2018

Congressional Committees

In recent years, the Small Business Administration's (SBA) 7(a) program—SBA's largest loan guarantee program for small businesses—has grown considerably.¹ The program is required to serve creditworthy small business borrowers who cannot obtain credit through a conventional lender at reasonable terms—commonly referred to as the “credit elsewhere” requirement.² In July 2015, SBA was forced to suspend 7(a) lending after the program hit its \$18.75 billion annual loan ceiling with more than 2 months left in the fiscal year. Congress subsequently raised the loan ceiling to \$23.5 billion and further to \$27.5 billion in fiscal year 2017. In response to this growth, members of Congress have raised concerns about guaranteed loans going to borrowers that are able to obtain conventional credit at reasonable terms and whether the criteria currently used to satisfy the credit elsewhere requirement provide reasonable assurance that guaranteed loans are approved for only qualified borrowers.

The Joint Explanatory Statement of the Consolidated Appropriations Act, 2017, includes a provision for us to conduct a study of the credit elsewhere requirement, including the sufficiency of the credit elsewhere criteria. This report discusses (1) 7(a) lending to selected categories of small business borrowers from fiscal years 2007 through 2016; (2) how SBA monitors lenders' compliance with the credit elsewhere requirement; (3) the extent to which SBA evaluates trends in lender practices related to the credit elsewhere requirement; and (4) lenders' views on the criteria used to determine eligibility for 7(a) loans and other issues related to the 7(a) program.

¹The loan guarantee covers part of a lender's losses in the event of a borrower default, reducing the risk of lending to small businesses that would otherwise not qualify for loans at reasonable terms from commercial lenders. Section 7(a) of the Small Business Act, now codified at 15 U.S.C. § 636(a), provides the authority for the 7(a) program.

²Reasonable terms and conditions take into consideration “the prevailing rates and terms in the community in or near which the concern transacts business, or the homeowner resides, for similar purposes and periods of time.” 15 U.S.C. § 632(h). SBA also requires lenders certify that 7(a) borrowers cannot obtain financing from personal resources or the resources of the business or its owners of 10 percent or more.

To determine 7(a) lending to selected categories of small business borrowers, we identified the characteristics of small business borrowers that receive SBA-guaranteed loans through the 7(a) program. To do so, we analyzed loan-level data from SBA on the characteristics of small businesses that received 7(a) loans from fiscal years 2007 through 2016, the most current information available at the time of our review, including whether businesses were women-owned or minority-owned and their geographic location. To assess the reliability of loan-level data from SBA, we interviewed SBA officials, reviewed related documentation, and tested the data for missing or erroneous values. We determined the data we used were sufficiently reliable for purposes of describing the characteristics of borrowers who received 7(a) loans.

To examine how SBA conducts oversight of 7(a) lenders' compliance with the credit elsewhere requirement, we reviewed SBA's standard operating procedures and other guidance, interviewed SBA officials, and reviewed reports of SBA's on-site reviews, corrective actions, and targeted lender reviews related to the credit elsewhere requirement conducted in fiscal year 2016. To assess the extent to which SBA evaluates trends in lender practices related to the credit elsewhere requirement, we interviewed SBA officials and reviewed documentation for SBA's online portal for loan origination. To obtain lenders' views on the adequacy of the criteria SBA uses to determine eligibility for 7(a) loans and other issues related to the 7(a) program, we interviewed representatives from industry groups and a nonrepresentative, nongeneralizable sample of 11 lenders, of which 9 lenders were selected using a random process that concentrated on larger lenders and two additional lenders we interviewed that represented an industry group. Appendix I describes our objectives, scope, and methodology in greater detail.

We conducted this performance audit from August 2017 to June 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Under SBA's 7(a) loan program, SBA guarantees loans made by commercial lenders to small businesses for working capital and other general business purposes.³ These lenders are mostly banks, but some are non-bank lenders, including small business lending companies—lenders whose lending activities are not subject to regulation by any federal or state regulatory agency, but were previously licensed by SBA and authorized to provide 7(a) loans to qualified small businesses.⁴ The guarantee assures the lender that if a borrower defaults on a loan, the lender will receive an agreed-upon portion (generally between 50 percent and 85 percent) of the outstanding balance. For a majority of 7(a) loans, SBA relies on lenders with delegated authority to approve and service 7(a) loans and to ensure that borrowers meet the program's eligibility requirements. To be eligible for the 7(a) program, a business must be an operating for-profit small firm (according to SBA's size standards) located in the United States and must meet the credit elsewhere requirement.⁵

Because the 7(a) program is required to serve borrowers who cannot obtain conventional credit at reasonable terms, lenders making 7(a) loans must take steps to ensure that borrowers meet the program's credit elsewhere requirement. Because SBA relies on lenders with delegated authority to make these determinations, SBA's oversight of these lenders is particularly important. However, we found in a 2009 report that SBA's lack of guidance to lenders on how to document compliance with the credit elsewhere requirement was impeding the agency's ability to oversee compliance with the credit elsewhere requirement. To improve

³Although SBA has legislative authority to make direct loans to borrowers unable to obtain loans from conventional lenders, SBA has, with the exception of disaster loans and loans to Microloan program intermediaries, not exercised that authority since 1998.

⁴As of the first quarter of fiscal year 2018, small business lending companies accounted for less than 4 percent of SBA's total 7(a) loan portfolio, excluding loans made through SBA's Community Advantage pilot program.

⁵In establishing size standards, SBA considers economic characteristics of the industry, including degree of competition; average firm size; start-up costs and entry barriers; and distribution of firms by size. It also considers growth trends, competition from other industries, and other factors that may distinguish small firms from other firms. SBA's size standards seek to ensure that a firm that meets a specific size standard is not dominant in its field of operation. The Small Business Jobs Act of 2010 also mandated that SBA establish an alternative size standard for 7(a) applicants using maximum tangible net worth and average net income after federal income taxes. See Pub. L. No. 111-240 § 1116 (codified at 15 U.S.C. § 632(a)(5)). Until 2014, borrowers also had to meet the "personal resources test," which required certain owners to inject personal liquid assets into the business to reduce the amount of SBA-guaranteed funds that would otherwise be needed.

SBA's oversight of lenders' compliance with the credit elsewhere requirement, we recommended in 2009 that SBA issue more detailed guidance to lenders on how to document their compliance with the credit elsewhere requirement.⁶ As a result, SBA revised its standard operating procedure to state that each loan file must contain documentation that specifically identifies the factors in the present financing that meet the credit elsewhere test, which we believe met the spirit of our recommendation.

SBA's current credit elsewhere criteria for determining 7(a) loan eligibility include the following factors:

1. the business needs a longer maturity than the lender's policy permits;
2. the requested loan exceeds the lender's policy limit regarding the amount that it can lend to one customer;
3. the collateral does not meet the lender's policy requirements;
4. the lender's policy normally does not allow loans to new businesses or businesses in the applicant's industry; or
5. any other factors relating to the credit which, in the lender's opinion, cannot be overcome except for the guarantee.

When the 7(a) program was first implemented, borrowers were generally required to show proof of credit denials from banks that documented, among other things, the reasons for not granting the desired credit. Similar requirements remained in effect until 1985, when SBA amended the rule to permit a lender's certification made in its application for an SBA guarantee to be sufficient documentation.⁷ This certification requirement remained when the rule was rewritten in 1996. SBA stated that it believed requiring proof of loan denials was demoralizing to small businesses and unenforceable by SBA.

⁶GAO, *Small Business Administration: Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight*, GAO-09-228 (Washington, D.C.: Feb. 12, 2009).

⁷By signing the loan guarantee application, the lender is certifying that "without the participation of SBA, to the extent applied for, [the lender] would not be willing to make this loan, and, in [the lender's] opinion, the financial assistance applied for is not otherwise available on reasonable terms."

SBA and lender roles vary among 7(a) program categories—including regular 7(a), the Preferred Lenders Program, and SBA Express.⁸ Under the regular (nondelegated) 7(a) program, SBA makes the loan approval decision, including the credit determination. Under the Preferred Lenders Program and SBA Express, SBA delegates to the lender the authority to make loan approval decisions, including credit determinations, without prior review by SBA. For each 7(a) program category, lenders are required to ensure that borrowers meet the credit elsewhere requirement for all 7(a) loans. The maximum loan amount under the SBA Express program is \$350,000, as opposed to \$5 million for other 7(a) loans. The program allows lenders to utilize, to the maximum extent possible, their own credit analyses and loan underwriting procedures. In return for the expanded authority and autonomy provided by the program, SBA Express lenders agree to accept a maximum SBA guarantee of 50 percent. Other 7(a) loans generally have a maximum guarantee of 75 percent or 85 percent, depending on the loan amount. In fiscal year 2016, 1,991 lenders approved 7(a) loans, of which 1,321 approved at least one loan with some form of delegated authority.

SBA's Office of Credit Risk Management is responsible for overseeing 7(a) lenders, including those with delegated authority. SBA created this office in fiscal year 1999 to help ensure consistent and appropriate supervision of SBA's lending partners.⁹ The office is responsible for managing all activities regarding lender reviews; preparing written reports; evaluating new programs; and recommending changes to existing programs to assess risk potential. Generally, the office oversees SBA lenders to identify unacceptable risk profiles using its risk rating system and enforce loan program requirements.¹⁰ According to SBA's standard operating procedures, one of the agency's purposes of its monitoring and

⁸According to SBA, other categories include Export Express; which processes delegated loans, International Trade Loans, which can process both nondelegated and delegated loans; and Export Working Capital Program, which can process both nondelegated and delegated loans. Additionally, the Community Advantage is a pilot loan program introduced by SBA to meet the credit, management, and technical assistance needs of small businesses in underserved markets. Community Advantage provides mission-oriented lenders access to 7(a) loan guaranties for loans of \$250,000 or less.

⁹Prior to a reorganization in May 2007, the office was called the Office of Lender Oversight.

¹⁰GAO, *Small Business Administration: Actions Needed to Improve the Usefulness of the Agency's Lender Risk Rating System*, GAO-10-53 (Washington, D.C.: Nov. 6, 2009).

oversight activities is to promote responsible lending that supports SBA's mission to increase access to capital for small businesses.

In the federal budget, the 7(a) program is generally required to set fees that it charges to lenders and borrowers at a level to cover the estimated cost of the program associated with borrower defaults (in present value terms). To offset some of the costs of the program, such as default costs, SBA assesses lenders two fees on each 7(a) loan. First, depending on the term of the loan, the guarantee fee must be paid by the lender within either 90 days of loan approval or 10 business days of the SBA loan number being assigned.¹¹ This fee is based on the amount of the loan and the level of the guarantee, and lenders can pass the fee on to the borrower. Second, the servicing fee must be paid annually by the lender and is based on the outstanding balance of the guaranteed portion of the loan.¹²

The 7(a) program accounts for a small portion of total small business lending. According to a May 2017 report by the Consumer Financial Protection Bureau, the total debt financing available to small businesses was estimated to be \$1.4 trillion. Of that amount, the Consumer Financial Protection Bureau estimated that about 7 percent was SBA loans, including 7(a) loans.¹³

SBA and some other researchers have suggested that there may be disparities in credit access among small businesses, based on characteristics of the borrower and firm. SBA lists as a strategic objective to "ensure inclusive entrepreneurship by expanding access and

¹¹Prior to September 2017, lenders were required to submit the guarantee fee at the time of the loan application (instead of within 10 days of loan approval) for loans with maturities of 12 months or less.

¹²The servicing fee cannot exceed 0.55 percent of the outstanding balance of the guaranteed portion and is required to be no more than "the rate necessary to reduce to zero the cost to the Administration of making guarantees." See 15 U.S.C. § 636(a)(23)(A). This fee cannot be charged to the borrower.

¹³In addition to the 7(a) loan program, SBA has two other capital loan programs—504 loans and Microloans. 504 loans are long-term, fixed-rate loans of up to \$5.5 million to support investment in major assets such as real estate and heavy equipment that are delivered by certified development companies (private, nonprofit corporations). Microloans are loans provided to nonprofit intermediary lenders (community-based organizations) that in turn make loans of up to \$50,000 to small businesses needing financing or assistance for start-up or expansion. In fiscal year 2016, SBA approved \$4.7 billion and \$58 million in 504 loans and Microloans, respectively (by gross loans approved).

opportunity to small businesses and entrepreneurs in communities where market gaps remain.” In 2007, we reported that some studies had noted disparities among some races and genders in the conventional lending market, but the studies did not offer conclusive evidence on the reasons for those differences.¹⁴ Much of the research we reviewed in 2007 relied on the Board of Governors of the Federal Reserve System’s Survey of Small Business Finance, which was last implemented in 2003.¹⁵ Although this survey is no longer available, recently the 12 Federal Reserve Banks conducted the Small Business Credit Survey.¹⁶ In a series of reports based on the more recent survey, researchers found disparities in credit availability based on gender, the age of the firm, and minority status.¹⁷

¹⁴GAO, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program’s Performance*, GAO-07-769 (Washington, D.C.: July 13, 2007).

¹⁵The survey gathered data from 4,240 firms selected to be representative of small businesses operating in the United States at the end of 2003.

¹⁶The Small Business Credit Survey is a national collaboration among the 12 Federal Reserve Banks. In 2016, it yielded 10,303 responses from small businesses with employees, or employer firms, located in 50 states and the District of Columbia.

¹⁷See for example, Federal Reserve Banks of Cleveland and Atlanta, *Small Business Credit Survey: Report on Minority-Owned Firms*, November 2017; Federal Reserve Banks of New York and Kansas City, *Small Business Credit Survey: Report on Women-Owned Firms*, (November 2017); and Federal Reserve Bank of New York, *Small Business Credit Survey: Report on Start-Up Firms*, November 2017.

Businesses That Were New, Women- Owned, or Located in Distressed Areas Received a Majority of 7(a) Loan Dollars over the Past 10 Years

From fiscal years 2007 through 2016, a majority of loan dollars guaranteed under the 7(a) program went to small businesses that were new, partially or wholly owned by women, or located in a distressed area.¹⁸ As previously mentioned, recent studies we reviewed by the Federal Reserve Banks and other researchers suggest that certain small business borrowers—including businesses that are new or owned by women—have difficulty obtaining conventional small business loans, which may put them at a disadvantage.¹⁹ As shown in figure 1, almost two-thirds of loan dollars guaranteed under the 7(a) program for this period went to small businesses that were in these two categories or located in a distressed area.²⁰ The remaining 37 percent of 7(a) loan dollars went to businesses that were established, solely male-owned, and not located in economically distressed areas. See appendixes II and III for additional data on 7(a) loans, such as the total volume, percentage of lending provided by year and by state, and other borrower characteristics, including SBA's loan- and lender-level Small Business Risk Portfolio Solutions score (predictive score) information.²¹

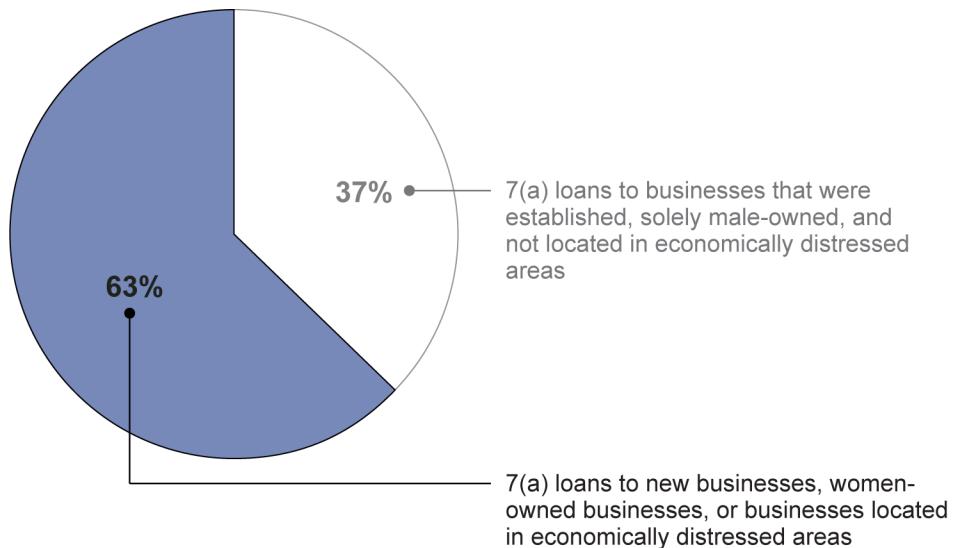
¹⁸SBA defines new businesses as businesses in operation 2 years or less at the time the loan is approved or, in some cases, within 2 years of a change of ownership. We determined economically distressed areas using American Community Survey data, discussed in greater detail below.

¹⁹Other studies reviewed include Sterling A. Bone, Glenn L. Christensen, Jerome D. Williams, Stella Adams, Anneliese Lederer, and Paul C. Lubin, “*Detecting Discrimination in Small Business Lending*” (2017), *Management Faculty Publications*, Paper 366, accessed on April 25, 2018, http://digitalcommons.usu.edu/manage_facpub/366; and Shaoming Cheng, “Potential Lending Discrimination? Insights from Small Business Financing and New Venture Survival,” *Journal of Small Business Management* 2015 53(4), pp. 905–923.

²⁰For 7(a) loans over this period, borrowers did not report race and ethnicity for about 11 percent of the loans. We present statistics based on minority status separately to more clearly identify the three categories: minority, nonminority, and undetermined.

²¹According to SBA, the Small Business Risk Portfolio Solutions score is a portfolio management credit score that is used by SBA to predict the likelihood of severe delinquency at the loan level. These scores risk rank loans based on their probability of severe delinquency within a range between 70 and 300. As scores increase for a given set of loans, the probability of delinquency decreases.

Figure 1: Percentage of 7(a) Loan Dollars That Went to Businesses That Were New, Women-Owned, or Located in Distressed Areas, Fiscal Years 2007–2016



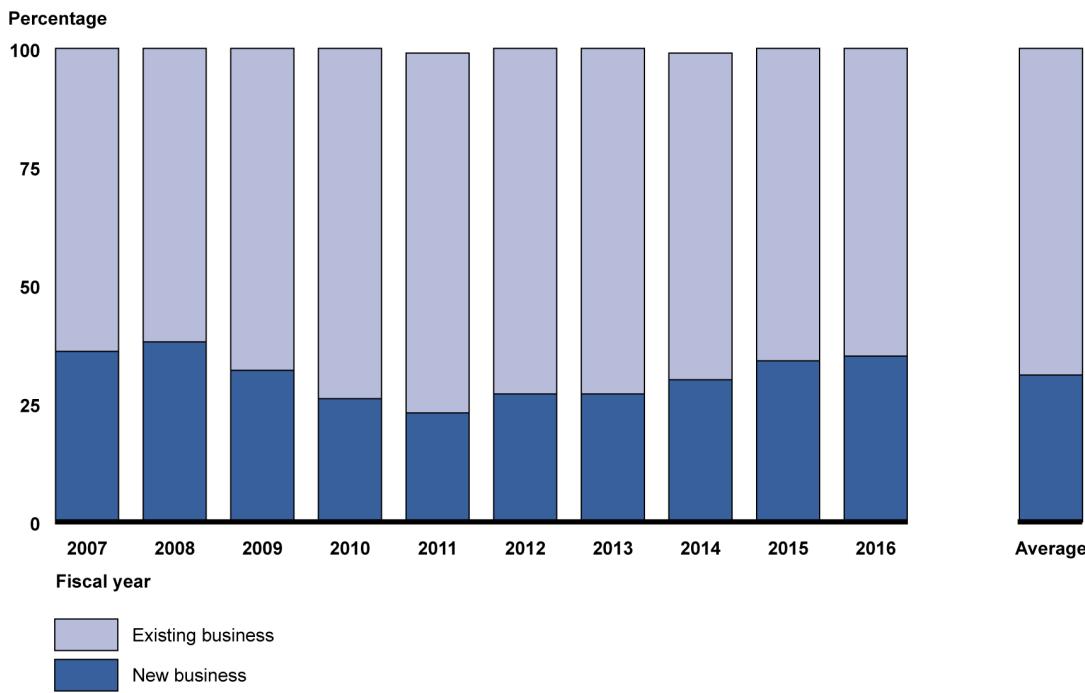
Source: GAO analysis of Small Business Administration and Census Bureau data. | GAO-18-421

Note: Data for women-owned businesses include businesses that were partially or majority owned by women.

In the following figures, we present more detailed data on 7(a) loans to small businesses based on their status as a new business; gender of ownership; location relative to economically distressed areas; and minority ownership for fiscal years 2007 through 2016.

New businesses. As shown in figure 2, the percentage of 7(a) loans that went to new businesses decreased from 36 percent in fiscal year 2007 to 23 percent in fiscal year 2011 before increasing to 35 percent by 2016.

Figure 2: Percentage of 7(a) Loans by Status as a New Business, Fiscal Years 2007-2016

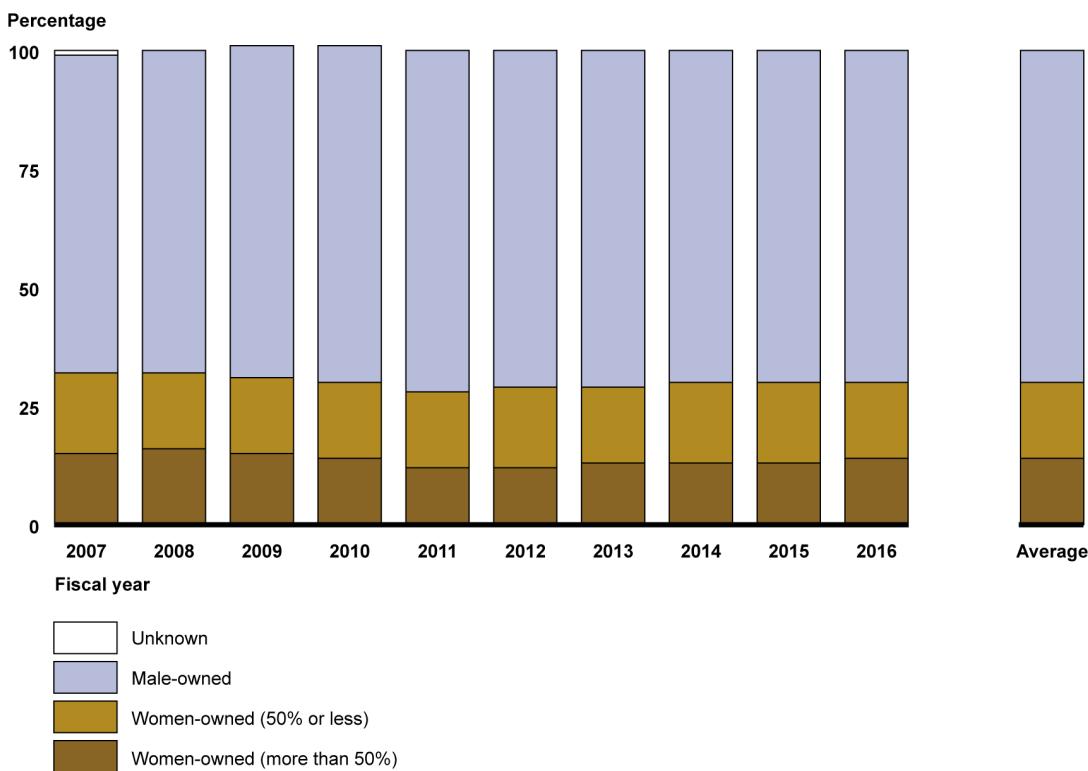


Source: GAO analysis of Small Business Administration data. | GAO-18-421

Gender. From fiscal years 2007 through 2016, the share of the total value of approved 7(a) loans by gender of owner remained fairly consistent (see fig. 3). An average of 70 percent of the total loan value went to male-owned businesses, and the remaining 30 percent went to businesses that were majority (more than 50 percent) or partially (50 percent or less) owned by women.²²

²²An SBA staff member told us that the gender of the owners of small business applicants is collected from the application form submitted by the applicant at the time of origination. The disclosure of this information is voluntary and used for statistical or reporting purposes only; it has no bearing on the credit decision.

Figure 3: Percentage of 7(a) Loans by Gender of Ownership, Fiscal Years 2007-2016



Source: GAO analysis of Small Business Administration data. | GAO-18-421

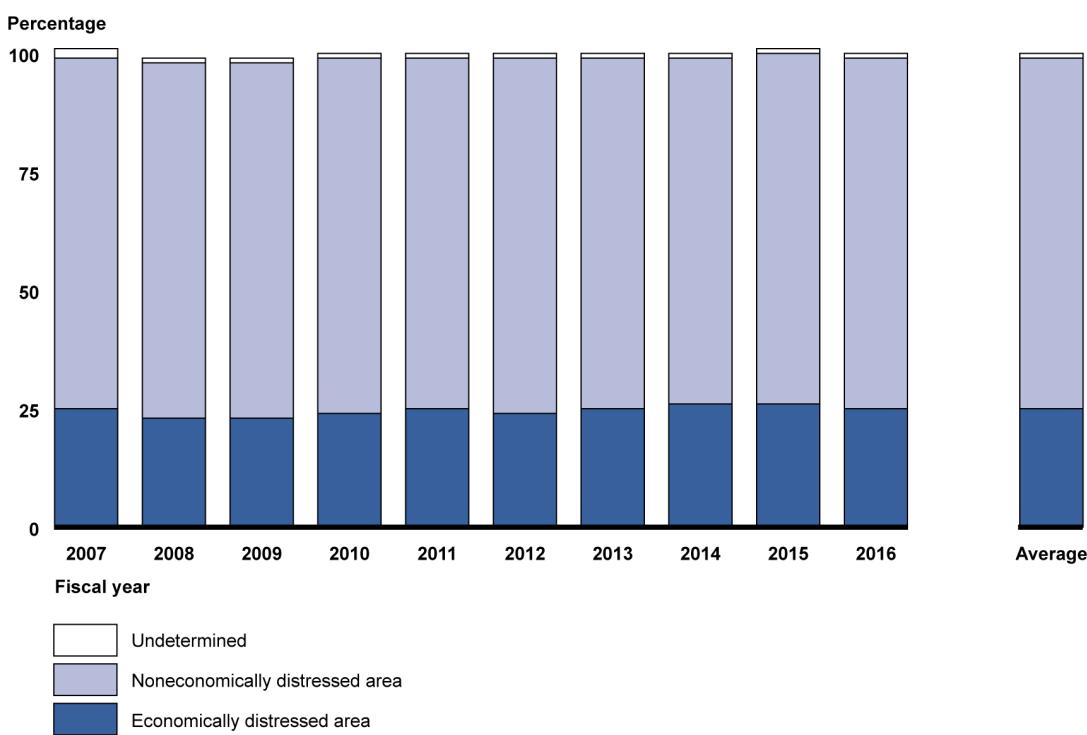
Notes: According to SBA, gender is voluntarily provided at the discretion of the borrower and may not be reliable.

Economically distressed areas. SBA did not provide data on whether 7(a) loans go to businesses located in economically distressed neighborhoods. However, we used data from the American Community Survey for 2011 through 2015, the most recent version available at the time of our analysis, along with zip code information provided by SBA to determine the average poverty rate by zip code (see fig. 4).²³ From fiscal

²³The American Community Survey is an ongoing survey conducted by the U.S. Census Bureau on topics such as social; economic; demographic; and housing characteristics of the U.S. population. The 5-year estimates from the survey are “period” estimates that represent data collected over a period of time. We merged the ACS data to the SBA data by zip code. Because in the ACS data poverty rate by zip code is only available for 5-year files, we could not obtain yearly poverty rates, so we merged in the average poverty rate over the period. Because of this, the analysis does not reflect yearly changes in poverty over the period.

years 2007 through 2016, the proportion of the total value of 7(a) loans approved that went to borrowers in economically distressed areas remained between 23 percent and 26 percent. We defined distressed areas as zip codes where at least 20 percent of the households had incomes below the national poverty line.

Figure 4: Percentage of 7(a) Loans to Borrowers in Economically Distressed Areas and Noneconomically Distressed Areas, Fiscal Years 2007–2016



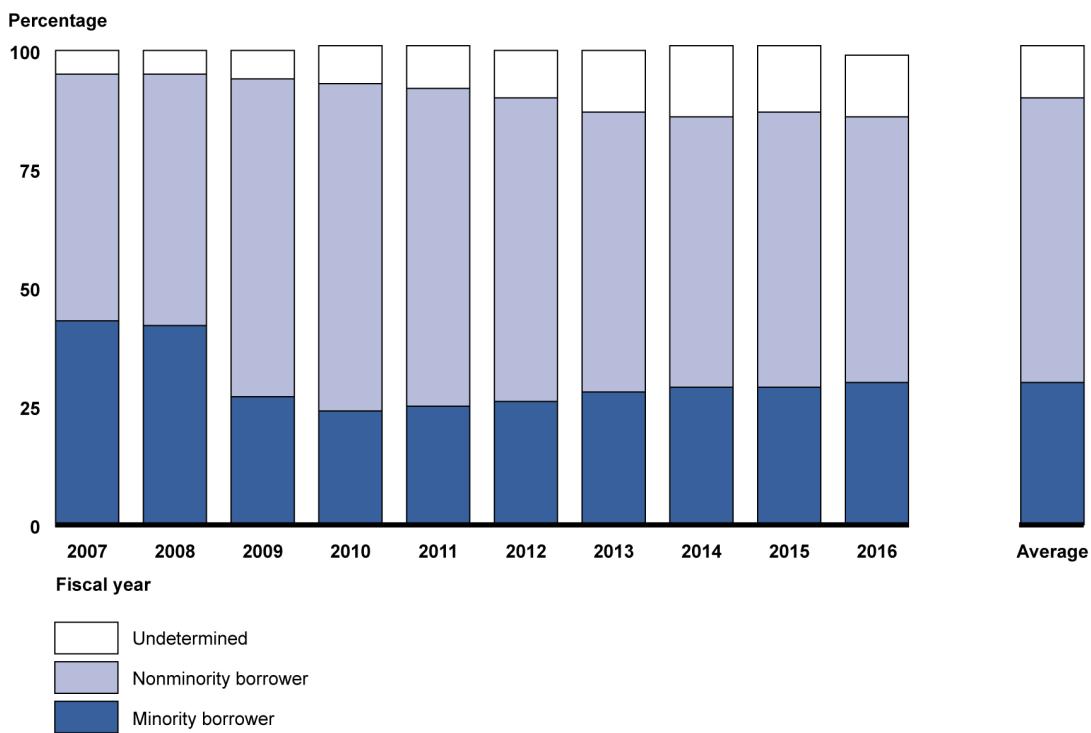
Source: GAO analysis of Small Business Administration and Census Bureau data. | GAO-18-421

Notes: A borrower was determined to be in an economically distressed area if the zip code associated with that borrower had a poverty rate of 20 percent or higher. In about 1 percent of the cases, we were unable to determine a poverty rate for that zip code, in which case it was undetermined whether the zip code met our criteria.

Minority/Nonminority status of borrower. From fiscal years 2007 through 2016, the proportion of the total value of 7(a) loans approved that went to minority borrowers decreased overall—from 43 percent to 30 percent—with the lowest share at 24 percent in fiscal year 2010 (see fig. 5).²⁴ The share of approved loan dollars that went to nonminority borrowers varied, increasing to 69 percent in fiscal year 2010 before decreasing to 56 percent in fiscal year 2016. Notably, the share of the total value of loans approved that went to borrowers whose race/ethnicity was categorized as undetermined increased from 5 percent in fiscal year 2007 to 13 percent in fiscal year 2016. This increase does not fully account for the declined share for minority borrowers. However, according to SBA officials, borrowers voluntarily provide self-reported information on race and ethnicity and therefore the associated trend data should be viewed with caution.

²⁴We define minority-owned businesses as those whose majority owner or owners are American Indian; Asian or Pacific Islander; Black or African American; Hispanic or Latino; Eskimo or Aleuts; Puerto Rican or Multi-group.

Figure 5: Percentage of 7(a) Loans to Minority and Nonminority Borrowers, Fiscal Years 2007–2016



Source: GAO analysis of Small Business Administration data. | GAO-18-421

Notes: Race and ethnicity are voluntarily provided at the discretion of the borrower. The undetermined category represents borrowers that did not identify their race or ethnicity.

SBA data contained nine categories for race/ethnicity, including one category for undetermined. Figure 5 condenses the nine categories into three groups: nonminority borrowers (borrowers who reported their race/ethnicity as white), minority borrowers (borrowers who reported categories other than white), and undetermined.

SBA Has Processes in Place to Evaluate Lender Compliance, but Its Lender Reviews Do Not Document Reasons for Noncompliance

SBA Conducts On-site and Targeted Lender Reviews to Evaluate Lender Compliance with the Credit Elsewhere Documentation Requirement

SBA relies on on-site reviews as its primary mechanism for evaluating lenders' compliance with the credit elsewhere requirement. The reviews are performed by third-party contractors with SBA staff participation and additional oversight from SBA. According to SBA's standard operating procedures, these reviews are generally conducted every 12 to 24 months for all 7(a) lenders with outstanding balances on the SBA-guaranteed portions of their loan portfolios of \$10 million or more, although SBA may conduct on-site reviews of any SBA lender at any time as it considers necessary. In fiscal year 2016, SBA conducted 40 on-site reviews of 7(a) lenders, representing approximately 35 percent of SBA's total outstanding 7(a) loan portfolio.²⁵

As part of SBA's on-site reviews, reviewers judgmentally selected a sample of approximately 30 to 40 loan files using a risk-based approach. These loan files accounted for approximately 6 percent to 19 percent of each lender's total gross SBA dollars in fiscal year 2016.²⁶ For each

²⁵The 35 percent represents the sum of the 40 lenders' gross balance (\$25.7 billion) divided by SBA's total 7(a) loan portfolio as of the fourth quarter of fiscal year 2015 (\$73.2 billion).

²⁶These figures represent the 25th and 75th percentile, respectively, for the 40 on-site reviews conducted in fiscal year 2016. The number of loan files in the sample ranged from 29 to 81 (median = 32). The percentage of total gross SBA dollars ranged from 1 percent to 95 percent (median = 10 percent). The loan selection criteria were mostly based on potential risk to SBA as evidenced from lenders' Lender Profile Assessment metrics and other areas of emerging risk. The Lender Profile Assessment is a data-driven off-site review that computes quantitative factors for the following five components: portfolio performance; asset management; regulatory compliance; risk management; and special items. These quantitative factors are then scored against set risk tolerance levels established by SBA.

lender, approximately 70 percent to 90 percent of the loan files in the sample were reviewed to evaluate compliance with the credit elsewhere requirement.²⁷ According to SBA's contractors, loans that were selected for other reasons, such as issues related to liquidation, were not required to be reviewed for credit elsewhere compliance.

SBA requires lenders to provide a narrative to support the credit elsewhere determination in the credit memorandum included in each loan file. SBA's standard operating procedures state that lenders must substantiate that credit is not available elsewhere by (1) discussing the criteria that demonstrate an identifiable weakness in a borrower's credit and (2) including the specific reasons why the borrower does not meet the lender's conventional loan policy requirements.

In keeping with SBA's documentation requirement, third-party contractors and SBA staff who conduct on-site reviews are supposed to assess whether lenders have adequately documented the credit elsewhere criteria and provided specific reasons supporting the criteria in the credit memorandum. According to SBA's contractors, adequate documentation of the credit elsewhere determination in the credit memorandum would include not just which of the criteria a borrower met but also a discussion of the basis or justification for the decision. For example, if a lender determined that a borrower needed a longer maturity, the lender should explain in the credit memorandum the reasons why a longer maturity was necessary. SBA's contractors also told us that they carefully review a lender's loan policies in preparation for on-site reviews and refer to a lender's policies throughout the reviews. Reviewers do not attempt to verify the evidence given in support of the credit elsewhere reason beyond the information provided in the credit memorandum.

Based on our review of fiscal year 2016 reports, on-site reviews can result in three levels of noncompliance response:

- **Finding:** This is the most severe result and is associated with a corrective action for the lender to remedy the issue.
- **Observation:** This is a deficiency recorded in the review's summary but may not warrant a corrective action for the lender.

²⁷These figures represent the 25th and 75th percentile, respectively, for the 40 reviews. The percentage of loan files of the sample that were reviewed for the credit elsewhere requirement ranged from 20 percent to 100 percent (median = 83 percent).

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- **Deficiency Noted:** This is the lowest level of response. It is a deficiency noted as part of the review that is not included in the review's summary and also may not warrant a corrective action.

According to SBA officials, SBA's policy has been that any noncompliance with SBA loan program requirements results in a finding. However, according to SBA officials and our review of the fiscal year 2016 on-site review reports, if a single instance of noncompliance was identified in fiscal year 2016, SBA generally would not issue a finding. Instead, SBA's contractors said they would attempt to determine whether that instance was an inadvertent error, such as by examining additional loan files.

Lenders that are subject to corrective actions are generally required to submit a response to SBA within 30 days to document how they have addressed or plan to address the identified issues. SBA subsequently asks for documentation to show that the lender has remedied the issue, and in some cases will conduct another review that usually includes an assessment of 5 to 10 additional loan files to determine whether the credit elsewhere reason has been adequately documented. According to SBA officials, SBA may also review lenders' compliance with corrective actions from recent on-site reviews during targeted reviews (discussed below) and delegated authority renewal reviews (for lenders with delegated authority).²⁸

In addition to on-site reviews, SBA also monitors lenders' compliance with the credit elsewhere requirement through targeted reviews (performed on- or off-site). Targeted reviews of a specific process or issue may be conducted for a variety of reasons at SBA's discretion, including assessing a lender's compliance with the credit elsewhere requirement. In fiscal year 2016, SBA conducted 24 targeted reviews that included an examination of lenders' compliance with the credit elsewhere documentation requirement. For these reviews, SBA examined loan files for 5 judgmentally selected loans that were provided to SBA electronically, as well as copies of the credit elsewhere reasoning (among

²⁸Lenders with delegated authority, such as Preferred Lenders Program status, are subject to periodic delegated authority renewal reviews to maintain their authority.

other underwriting documentation) for 10 additional recently-approved loans.²⁹

SBA also conducts periodic off-site reviews that use loan- and lender-level portfolio metrics to evaluate the risk level of lenders' 7(a) portfolios. According to agency officials, SBA also began using off-site reviews to evaluate lenders' compliance with the credit elsewhere requirement in fiscal year 2016. In that year, SBA conducted off-site reviews of 250 lenders and required these lenders to report the credit elsewhere justification for a sample of 10 loans per lender that were identified by SBA's selection process.³⁰ Lenders were not required to provide supporting documentation, and SBA did not follow up with lenders or review loan files to ensure the validity of the self-reported reasons. According to SBA, off-site reviews followed the same procedures in fiscal year 2017 as in 2016 and that the agency planned to use the same procedures for these reviews in the future. According to the agency, it also routinely evaluates and revises its review processes and procedures.

In addition, SBA's Loan Guaranty Processing Center and National Guaranty Purchase Center conduct Improper Payments Elimination and Recovery Act and quality control reviews at the time of loan approval and at the time of guaranty purchase, respectively.³¹ These reviews examine the credit elsewhere requirement, among other issues. Lastly, since 2014 SBA's Office of Inspector General has also examined whether high-dollar

²⁹The five judgmentally selected loans were selected based on potential risk to SBA as evidenced by Loan Portfolio Assessment metrics and other areas of emerging risk. Our characterization of the scope of these targeted reviews is based on our review of 7 of the 24 targeted reviews, which SBA identified as those reviews that identified issues with the credit elsewhere requirement.

³⁰For each lender, loans were selected among those that were disbursed within 24 months of the lender reporting cut-off date; approved through the Preferred Lenders Program or Certified Lenders Program; had approval amounts greater than \$350,000; and were nonacquired. The selection process was further targeted towards loans with larger approval amounts; loans that were more recently disbursed; loans that were disbursed using a loan agent; and loans that were disbursed in the top industry group.

³¹The Improper Payments Elimination and Recovery Act, as amended, requires among other things that federal executive branch agencies take actions to reduce improper payments, including a thorough review of available databases before the release of federal funds. See Improper Payments Elimination and Recovery Improvement Act of 2012, Pub. L. No.112-248, 126 Stat. 2390 (Jan. 10, 2013), codified at 31 U.S.C. 3321 note, as amended by the Bipartisan Budget Act of 2013, Pub. L. No. 113-67, § 204, 127 Stat. 1165, 1181 (Dec. 26, 2013), and the Federal Improper Payments Coordination Act of 2015, Pub. L. No. 114-109, §§ 2-4, 129 Stat. 2225, 2225-27 (Dec. 18, 2015).

or early-defaulted 7(a) loans were made in accordance with rules; regulations; policies; and procedures, including the credit elsewhere requirement.

SBA's Lender Reviews in 2016 Identified a High Rate of Noncompliance with the Credit Elsewhere Documentation Requirement

Our review of the on-site reviews conducted in fiscal year 2016 found that 17 of the 40 reviews—more than 40 percent—identified compliance issues with the credit elsewhere documentation requirement. Of those 17 reviews,

- 10 reviews resulted in a Finding (all with associated corrective actions),
- 3 reviews resulted in an Observation (none with associated corrective actions or requirements), and
- 4 reviews resulted in a Deficiency Noted (one with an associated requirement).

For all of the 17 on-site reviews that identified an instance of noncompliance, the issue was related to the lender's documentation of the credit elsewhere criteria or justification.³² For example, one review found that the lender's "regulatory practices demonstrate material noncompliance with SBA Loan Program requirements regarding documentation of the Credit Elsewhere Test." Another review found that the lender "failed to demonstrate with adequate documentation that credit was not available elsewhere on reasonable terms and conditions." For 2 of the 17 reviews, the issue was partly related to a discrepancy between the credit elsewhere justification used for some of the sample loan files and the lender's own loan policy limits.³³

With regard to SBA's targeted reviews, 7 of 24 reviews (29 percent) conducted in fiscal year 2016 found a compliance issue with the credit elsewhere requirement. Of those 7 reviews,

³²A given lender can be cited for multiple issues that result in a single finding.

³³Specifically, one of the reviews found that in three of the loan files reviewed, the credit elsewhere reasons did not appear to be justified. The loan files in question stated that credit was not available elsewhere as the debt service coverage was insufficient based on the lender's policy; however, in all three instances, the debt service coverage was well within the lender's policy limits. The second review found that in five of the loan files reviewed, the reason given was that the loan did not meet the lender's conventional loan guidelines although that lender was only authorized to make SBA loans.

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- 6 reviews resulted in a Finding (all with associated corrective actions),
 - 1 review resulted in an Observation (without an associated corrective action), and
 - no reviews resulted in a Deficiency Noted.

For all of the 7 targeted reviews that identified a compliance issue, the issue was wholly related to the lender's documentation of the credit elsewhere reason or justification. For example, 4 reviews found that for at least one loan reviewed, "the Lender failed to document justification that credit was unavailable elsewhere." Another review found that for "three SBA Express loans and one Small Loan Advantage loan [the lender] reported "other factors relating to the credit that in the lender's opinion cannot be overcome except for the guaranty' without specific identification of the factors."

Lack of Internal Controls Led to Lender Noncompliance, but Were Not Documented by SBA's Reviews

Based on our review of on-site review reports and an interview with one reviewer, the key factors underlying lenders' high rate of noncompliance with the credit elsewhere documentation requirement were lenders' lack of proper internal controls and procedures and lack of awareness of the credit elsewhere documentation requirement.³⁴ In fiscal year 2016, SBA's corrective actions related to the credit elsewhere requirement required the lenders to establish or strengthen their policies; procedures; underwriting processes; or internal controls. In addition, contractors conducting the on-site reviews with whom we spoke stated that some lenders appeared to be unfamiliar with SBA's standard operating procedures or were unclear on how to interpret them.

For the 11 on-site reviews conducted in 2016 that included corrective actions, SBA generally required lenders to improve controls or procedures. For example, one lender was required to "correct its policy, modify its procedure, and amend its internal controls to ensure that its consideration and documentation of credit unavailable elsewhere identifies the specific fact(s) which are applicable to the specific loan and the determination is rendered and accurate for each individual SBA loan that it originates." Another lender was required to "improve underwriting processes and controls to ensure that the borrower meets the [credit

³⁴The second contractor we spoke to began conducting reviews for SBA at the beginning of 2017 and thus did not conduct on-site reviews during fiscal year 2016.

elsewhere] requirement” and to “document the loan file with the reasons for the determination.”

Similarly, for the six targeted reviews in 2016 that included corrective actions, SBA issued a general requirement for the lender to “identify the causes for the Findings and implement corrective actions.” Based on our review of these targeted reviews, lenders generally remedied or intended to remedy the issue by amending their internal controls or procedures.³⁵ For example, one lender stated that the “Credit Elsewhere test will be incorporated into the Credit Department process.” Another lender stated that it would “centralize all SBA underwriting and has developed an SBA addendum that will be utilized for all SBA-guaranteed loans.”

Although some of SBA’s on-site reviews for fiscal year 2016 identified factors leading to noncompliance, they generally did not document reviewers’ assessment of lenders’ policies and practices for complying with the credit elsewhere documentation requirement. SBA’s standard operating procedures state that the on-site reviewers should determine whether or not lenders’ policies and practices adhere to the requirement, but they do not require them to document their assessment of these policies and practices. Only 4 of the 40 fiscal year 2016 review reports that we examined included such an assessment. As a result, although SBA required corrective actions by the lender to address deficiencies, there usually was no record of the underlying factors that resulted in the lender’s noncompliance.

Federal internal control standards state that management should design control activities to achieve objectives and respond to risks, including appropriate documentation of transactions and internal control.³⁶ Because SBA does not require reviewers to document their assessment of lenders’ policies and practices for complying with the credit elsewhere documentation requirement, the agency does not have good information to help explain why so many lenders are not in compliance. This hinders SBA’s ability to take informed and effective actions to improve lender compliance with the requirement and ensure that the program is reaching its intended population.

³⁵SBA did not provide us with documentation of the lenders’ response for two of the six lenders.

³⁶GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014).

SBA Collects Limited Data on Criteria Used for Credit Elsewhere Justifications and Does Not Analyze Patterns in Lender Practices

SBA Collects Limited Data on Criteria Used for Credit Elsewhere Justifications

SBA does not routinely collect information on the criteria lenders use in their credit elsewhere justifications. As previously discussed, lenders are required to maintain documentation of borrower eligibility (including the credit elsewhere justification) in each loan file for loans approved through lenders' delegated authority. However, SBA cannot readily aggregate information on lenders' credit elsewhere justifications for both delegated and nondelegated loans:

- For delegated loans, lenders are required to certify the loan's credit elsewhere eligibility on E-Tran, SBA's online portal for origination of delegated and nondelegated loans. However, lenders are only required to check a box to certify that the loan file contains the required credit elsewhere justification and are not required to submit any additional information, including which of the criteria was used to make the determination. According to SBA officials, delegated loans account for loans approved by approximately 70 percent of lenders.
- For nondelegated loans, lenders are required to submit credit elsewhere documentation to be reviewed by SBA's Loan Guaranty Processing Center. For these loans, which comprise loans approved by the remaining 30 percent of lenders, SBA might maintain paper records of data on borrowers' eligibility but does not compile such data electronically and thus cannot readily aggregate the data for analysis.³⁷

Instead, SBA relies on on-site reviews or lender-reported information to review lenders' credit elsewhere justifications and collects limited data

³⁷The Loan Guaranty Processing Center has two locations: Citrus Heights, California and Hazard, Kentucky.

from these reviews. For its on-site reviews, SBA does not collect sample data on lenders' use of the credit elsewhere criteria. For its off-site reviews, SBA collected sample data on lenders' use of the credit elsewhere criteria based on 250 such reviews conducted in fiscal year 2016. For these reviews, SBA asked lenders to self-report a short description of the credit elsewhere justifications used for an SBA-selected sample of 10 loans.³⁸ However, as discussed earlier, SBA did not request or examine loan files as part of these off-site reviews and did not follow up with lenders or review loan files to ensure the validity of the self-reported reasons.

One reason why SBA does not routinely collect complete information on lenders' use of the credit elsewhere criteria is that SBA's loan origination system, E-Tran, is not equipped to record or tabulate this information. In addition, according to an SBA official, on-site reviews do not collect data on the credit elsewhere criteria because the loans reviewed are judgmentally selected and would not accurately represent the larger population.

Federal internal control standards state that management should use quality information to achieve the entity's objectives. To do so, management should identify the information needed to achieve the objectives and address the risks, obtain relevant data from reliable internal and external sources in a timely manner, and process the obtained data into quality information.³⁹ More robust information on lenders' credit elsewhere justifications, including the credit elsewhere criteria, would allow SBA to evaluate patterns in lender practices related to the credit elsewhere requirement and, in turn, help the agency ensure compliance with the requirement. In this context, generalizable data, which can be collected through random sampling, or complete data through required reporting for every loan would allow SBA to better understand patterns in lender practices across the 7(a) program. Further, nongeneralizable data, which are available through SBA's current off- and on-site review processes, would allow SBA to examine specific groups of lenders and could help SBA determine if it is necessary to collect additional data.

³⁸SBA's loan sample selection process gives more weight to loans with larger approval amounts and more recently disbursed loans (as of the time of the review). Data collected may also give more weight to loans that were disbursed using a loan agent and loans that were disbursed in certain industry groups.

³⁹[GAO-14-704G](#).

SBA Has Not Conducted Analysis to Determine If There Are Any Patterns of Noncompliance or Identified Lenders That May Be at Risk

SBA does not analyze the limited data it collects to help it monitor lenders' compliance with the credit elsewhere requirement. According to agency officials, SBA has not performed lender-level analyses of the criteria lenders use for their credit elsewhere justifications. Additionally, SBA has not analyzed 7(a) lenders' use of the "other factors" criterion—that is, factors not specified in the other criteria that, in the lender's opinion, cannot be overcome except for the guarantee—for example, by collecting data on the frequency of its use or examining why lenders rely on it. While some 7(a) lenders told us they avoided relying on the "other factors" criterion because it was vague and open to interpretation, some lenders have used it when a borrower's profile did not meet any of the other criteria. For example, one lender stated that this criterion was used for a borrower who was no longer a start-up but had experienced fluctuations in cash flow due to relocation or change in ownership. Another lender stated that the criterion was used more frequently during the 2007-2009 financial recession to extend financing to borrowers whose owners had experienced a home foreclosure but were otherwise sound.

Federal internal control standards state that management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.⁴⁰ Analyzing data on lenders' use of the credit elsewhere criteria as part of its monitoring procedures could help SBA determine whether there are patterns in lender practices related to the criteria that could predict lender noncompliance. For example, SBA could analyze lenders' use of the criteria along with lender review results and other data on loan characteristics and performance to determine whether certain patterns indicate that a lender might be applying the requirement inconsistently. Additionally, such analysis could inform SBA's selection of which lenders to review by improving its ability to identify lenders at risk of noncompliance with the credit elsewhere requirement. Better selection criteria for its lender reviews could, in turn, improve identification and remediation of such noncompliance, helping ensure that the 7(a) program serves its target population.

⁴⁰ GAO-14-704G.

Lenders Generally View Credit Elsewhere Criteria as Adequate, and SBA Has Implemented New Procedures for Reviewing Eligibility

Lenders Said Credit Elsewhere Criteria are Generally Adequate for Determining Borrower Eligibility

Representatives at 8 of the 11 lenders that we contacted said they believed that SBA's current credit elsewhere criteria are adequate in targeting small business borrowers who cannot obtain credit at reasonable terms.⁴¹ Representatives of these lenders also agreed that the criteria generally serve the types of small businesses that would otherwise have trouble obtaining conventional credit, such as new businesses or those with a shortage of collateral. One lender representative told us its most commonly used criterion related to the overall time in business because of the higher risk of failure. Another lender representative cited the lack of collateral as the most common criterion used. Additionally, representatives at an industry association told us that one of the most commonly used criteria was the one related to loan maturity and many small businesses seek 7(a) loans because they offer repayment terms of up to 10 years, compared to 1 to 3 years for conventional loans.

Representatives of two other lenders suggested that the credit elsewhere criteria should not be overly prescriptive, which could limit lenders' ability to make 7(a) loans to some businesses. For example, one representative

⁴¹Two lenders that represented a trade group commented that the criteria did cover many of the common reasons for offering a 7(a) loan, but they did not opine on whether the criteria were adequate. One other lender questioned whether the 7(a) program needed a credit elsewhere test explaining that the 7(a) loan program was slower to process and more expensive than a conventional loan. The lender representative added that borrowers who could get conventional financing would not take a 7(a) loan. Also, the sample of 11 lenders, of which 9 lenders were selected using a random process that concentrated on larger lenders and two additional lenders we interviewed representing an industry group, was nongeneralizable to the total population of 7(a) lenders. See appendix I for more information on lender selection.

said the credit elsewhere criteria should remain flexible because banks have different lending policies.

In addition, representatives at three lenders indicated that they were hesitant to use the “other factors” criterion. One lender believed the requirement was open to interpretation and could be used inappropriately with lenders determining their own individual conventional loan policies. Another lender commented that the criterion was vague and rarely used by his institution, noting that SBA should provide some additional guidance on its use.

Factors Such as Lender Policies and Economic Conditions Also Affect Lenders’ Decisions to Offer a SBA 7(a) Loan

Lenders consider multiple factors in determining whether to offer small businesses a conventional loan or a 7(a) loan, according to stakeholders with whom we spoke. For example, representatives at an industry association stated that a bank goes through several analyses to determine what loan product to offer the borrower. These representatives stated that the credit elsewhere requirement is embedded in the analysis a bank performs, such as whether the borrower qualifies for a loan and has a financial need for an SBA loan and whether the 7(a) program is right for that borrower.

Representatives at two other lenders also stated that many small businesses have already been turned down for conventional loans before they seek a 7(a) loan. One representative noted that the “reasonable rates and terms” component of the 7(a) program was important as it allows lenders to look more broadly at a borrower’s needs. For instance, the representative explained, lenders can assess whether repayment terms are reasonable given a particular borrower’s situation and the resources the borrower will have to repay the loan.

Economic conditions also affect lending policies, including whether borrowers qualify for a conventional loan, according to representatives at seven lenders with whom we spoke. For example, during the recent economic downturn, banks tightened their underwriting standards for small businesses and were less willing to lend without a government guarantee, according to one lender representative.

SBA Has Issued New Procedures for Reviewing Liquidity of Small Business Borrowers, and Additional Lender Training Is Underway

SBA has issued revised primary operational guidance for the 7(a) program, effective January 1, 2018.⁴² As discussed previously, lenders are required to make a determination that the desired credit is not available to the applicant from nonfederal sources. Under the previous guidance, the lender had to determine that some or the entire loan was not available from nonfederal sources or the resources of the applicant business. However under the revised guidance, the scope of nonfederal sources a lender must review was further defined to include sources both related and unrelated to the applicant. The updated guidance states that lenders must consider:

- Nonfederal sources related to the applicant, including the liquidity of owners of 20 percent or more of the equity of the applicant, their spouses and minor children, and the applicant itself⁴³; or
- Nonfederal sources unrelated to the applicant, including conventional lenders or other sources of credit.

Representatives of five lenders told us they have been determining how to interpret the new procedures with a few stating they would like additional guidance, including what information to retain in the file. Representatives of two lenders stated that there is some ambiguity in how to determine nonfederal resources and how to assess whether small business owners have too many available liquid resources to qualify for a 7(a) loan. One representative said that lenders can have different interpretations of what constitutes “available resources,” which is not specified in the new SOP. As a result, he said, there may be some confusion about how to assess family members of the borrower who have high net worths and whether the borrower should decline a family member contribution to qualify for an SBA loan. A representative of one lender stated that lenders will not know what SBA expects until loans are approved under the new procedures, default, and are then reviewed. Another lender’s representative suggested additional guidance on

⁴²SBA, SBA SOP 50 10 5 (J), Lender and Development Company Loan Programs, (Jan. 1, 2018).

⁴³SBA Policy Notice 5000-17057, effective April 3, 2018 increased the minimum percentage ownership at which owners are subject to personal liquidity consideration from 10 percent to 20 percent. The liquidity of the owner includes the liquid assets of the owner's spouse and any minor children. See SBA, SBA POLICY NOTICE 5000-17057, REVISED GUIDANCE ON CREDIT ELSEWHERE AND OTHER PROVISIONS IN SOP 50 10 5(J), 1 (Apr. 3, 2018).

documentation, such as whether the bank must obtain a personal financial statement for each owner of the business.

A SBA staff told us SBA has provided multiple training presentations to SBA staff, lenders, and trade associations on the statutory changes to the credit elsewhere requirements and standard operating procedure updates.⁴⁴ These have included a presentation at a trade association conference, four monthly conference calls for SBA staff, and two conference calls for SBA lenders. SBA staff said SBA also plans to hold monthly training sessions with SBA field offices, quarterly training sessions with the industry, and at least four training sessions in 2018 at lender trade conferences. Additionally, a representative from an industry association told us it is providing industry training on SBA's revised procedures, including the credit elsewhere liquidity requirement.

Conclusions

SBA's 7(a) loan program is required to serve creditworthy small business borrowers who cannot obtain credit through a conventional lender at reasonable terms, and SBA largely relies on lenders with delegated authority to make credit elsewhere determinations. However, although there is a high rate of lender noncompliance with the credit elsewhere documentation requirement, SBA does not require its reviewers to document their assessment of the policies and procedures lenders use to meet the requirement. Without better information from lender reviews on how lenders are implementing the requirement to document their credit elsewhere decisions, SBA may be limited in its ability to promote compliance with requirements and, in turn, use such information to help ensure that 7(a) loans are reaching their target population.

Furthermore, SBA does not routinely collect or analyze information on the criteria used for credit elsewhere justifications to evaluate patterns in lender practices. SBA recently began collecting some information on lenders' use of the criteria, but this information is limited, and SBA does not analyze the information that it does collect to better understand lenders' practices. Without more robust information and analysis, SBA may be limited in its ability to understand how lenders are using the credit elsewhere criteria and whether 7(a) loans are reaching borrowers who cannot obtain credit from other sources at reasonable terms.

⁴⁴According to SBA, these presentations included changes to the credit elsewhere requirement in the Veteran Entrepreneurship Act of 2015 and the subsequent standard operating procedure updates (both versions I and J).

Recommendations for Executive Action

We are making the following three recommendations to SBA.

The Administrator of SBA should require reviewers to consistently document their assessments of a lender's policies and practices. (Recommendation 1)

The Administrator of SBA should use its on-site and off-site reviews to routinely collect information on lenders' use of credit elsewhere criteria as part of its monitoring of lender practices related to the credit elsewhere requirement. (Recommendation 2)

The Administrator of SBA should analyze information on lenders' use of credit elsewhere criteria obtained from its reviews to identify lenders that may be at greater risk of noncompliance and to inform its selection of lenders for further review for credit elsewhere compliance. (Recommendation 3)

Agency Comments and Our Evaluation

We provided a draft of this report for review and comment. SBA's written comments are reprinted in appendix IV. SBA generally agreed with the recommendations. SBA also provided additional comments on certain statements in the draft report, which are summarized below with our responses.

- SBA noted that the draft Highlights did not discuss how credit elsewhere is determined for nondelegated loans. We have not revised the Highlights in response to this comment because our review focused on delegated lenders. In the body of the report we note that approximately 70 percent of 7(a) loans are approved under delegated authority. We also refer to SBA's nondelegated loans in the report for additional context.
- According to SBA, the statement on our draft Highlights did not fully reflect its monitoring of lender compliance. SBA identified a variety of reviews it uses in addition to on-site reviews by third party contractors, which we discuss in the body of the report. We have modified the Highlights to reflect these other reviews.
- Also in reference to the draft Highlights, SBA stated that it provides oversight on every on-site lender review and that an SBA employee is present as a subject-matter expert on every review. We revised the Highlights by adding that SBA provides oversight to the on-site reviews conducted by third-party contractors.

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- In response to a statement in our draft report that SBA guarantees loans to small businesses for working capital and other general business purposes, SBA commented that working capital generally is not the primary purpose for SBA-guaranteed loans. We did not revise the statement because SBA's SOP 50 10 5 (version J) specifies that SBA's 7(a) loan proceeds may be used for permanent working capital and revolving working capital, among other things.
 - In relation to a footnote in our report that mentions two lender reviews for which we did not receive documentation, SBA stated that on February 15, 2018, it provided documentation to us related to the reviews and that we had confirmed its receipt. However, the text in the footnote in question refers to two targeted lender reviews from 2016 that included corrective actions. The information SBA provided to us on February 15, 2018, was related to on-site reviews conducted in 2016. As a result, we did not revise the footnote.

SBA's letter also contained technical comments that we incorporated as appropriate.

We are sending copies of this report to congressional committees, agencies, and other interested parties. In addition, this report will be available at no charge on our website at <http://www.gao.gov>.

If you or your staff members have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix V.



William B. Shear
Director, Financial Markets and Community Investment

List of Committees

The Honorable James Risch
Chairman
The Honorable Benjamin Cardin
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate

The Honorable James Lankford
Chairman
The Honorable Christopher Coons
Ranking Member
Subcommittee on Financial Services and General Government
Committee on Appropriations
United States Senate

The Honorable Steve Chabot
Chairman
The Honorable Nydia Velázquez
Ranking Member
Committee on Small Business
House of Representatives

The Honorable Tom Graves
Chairman
The Honorable Mike Quigley
Ranking Member
Subcommittee on Financial Services and General Government
Committee on Appropriations
House of Representatives

Appendix I: Objectives, Scope, and Methodology

This report discusses (1) 7(a) lending to selected categories of small business borrowers from fiscal years 2007 through 2016; (2) how the Small Business Administration (SBA) monitors lenders' compliance with the credit elsewhere requirement; (3) the extent to which SBA evaluates trends in lender practices related to the credit elsewhere requirement; and (4) lenders' views on the criteria used to determine eligibility for 7(a) loans and other issues related to the 7(a) program.

For background on the 7(a) program and the credit elsewhere requirement, we reviewed the legislative history of the 7(a) program and our previous reports.¹ We also interviewed officials from SBA's Office of Credit Risk Management on guidance provided to 7(a) lenders.

For background on constraints in the small business credit market, we reviewed recent academic literature on the characteristics of small businesses that historically have had more difficulty accessing credit. In addition, we reviewed recent studies published by the Federal Reserve Banks of Atlanta; Cleveland; Kansas City; and New York.

To describe the population of borrowers served by the 7(a) program, we selected characteristics (such as gender, minority status, and percentage of new business) that we used in our 2007 report and that were the subject of the recent studies by Federal Reserve Banks.² We obtained and analyzed SBA loan-level data to describe 7(a) loans and borrowers. Specifically, SBA provided us with 581,393 records from its administrative data systems, which contained information on all loans approved and disbursed in fiscal years 2007 through 2016. The SBA data included various types of information describing each loan, including the total gross approval amount; the amount guaranteed by SBA; the loan term; and the interest rate; delivery method; and status of the loan. The SBA data also included information on borrower characteristics:

- **Age of business.** Firms were classified as new (less than 2 years in operation) or existing.

¹GAO, *Small Business Administration: Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight*, GAO-09-228 (Washington, D.C.: Feb. 12, 2009) and *Small Business Administration: Additional Measures Needed to Address 7(a) Loan Program's Performance*, GAO-07-769 (Washington, D.C.: July 13, 2007).

²GAO-07-769.

- **Gender.** Firms were classified as 100 percent male-owned; 50 percent or greater women owned; 50 percent or less women-owned; or “unknown.” Information on gender was voluntarily provided by borrowers.
- **Economically distressed area.** We identified borrowers in economically distressed areas by matching borrower zip codes provided by SBA to those in the 2011 through 2015 American Community Survey. We defined distressed areas as zip codes where at least 20 percent of households had incomes below the national poverty line. In about 1 percent of the cases, we were unable to classify a lender because a zip code had changed or had insufficient population to report a poverty rate. We consider 1 percent of unmatched cases to be low by data reliability standards.³
- **Race/ethnicity.** Borrowers were placed in one of nine categories of race/ethnicity, including an “unknown” category. We aggregated these to create minority, nonminority, and undetermined categories. The minority category included all borrowers who reported being a race/ethnicity other than white. The nonminority category included borrowers who reported being white. Information on race was voluntarily provided by borrowers.
- **Industry.** Firms were assigned a North American Industrial Classification code. These six-digit codes begin with a two-digit sector code that we used to draw more general conclusions about industries.⁴
- **Geographic information.** The data provided the state where the borrower is located.

In addition, we obtained information from SBA on loan- and lender-level Small Business Risk Portfolio Solution scores (predictive scores) provided by Dunn & Bradstreet and Fair Isaac Company, for loans approved in fiscal year 2016, the latest available. We were able to obtain predictive scores for approximately 81 percent of the loans for which SBA had provided other information. According to SBA, some loans may not have

³Our procedure for determining whether a zip code was economically distressed was a similar procedure to that used in our 2007 report; see [GAO-07-769](#).

⁴For example, all industry codes beginning with 72 are part of the sector “Accommodation and Food Services.” While North American Industrial Classification codes have been updated every 5 years since their implementation in 1997, these two-digit sector codes have not changed since 1997.

been disbursed at the time we obtained the predictive scores and, as a result, we do not have scores associated with these loans. We analyzed the information to determine the range of predictive scores and the range of average predictive scores by lender.

To assess the reliability of loan-level data on borrower and loan characteristics and predictive scores we received from SBA, we interviewed agency officials knowledgeable about the data and reviewed related documentation. We also conducted electronic testing, including checks for outliers, missing data, and erroneous values. We determined that the data were sufficiently reliable for the purposes of describing the characteristics of borrowers who received 7(a) loans and the distribution of predictive scores.

To assess how SBA monitors lenders' compliance with the credit elsewhere requirement and criteria, we reviewed SBA's standard operating procedures and other guidance on 7(a) program regulations and lender oversight. Specifically, we reviewed SOP 50 10 5 (versions I and J) on Lender and Development Company Loan Programs, SOP 50 53(A) on Lender Supervision and Enforcement, and SOP 51 00, On-Site Lender Reviews/Examinations, as well as information and policy notices related to the credit elsewhere requirement. Additionally, we interviewed representatives including those at SBA's Office of Capital Access and Office of Credit Risk Management on lender oversight and lender review processes. We reviewed all the on-site lender review reports (40 reviews), including corrective actions or requirements related to the credit elsewhere requirement (documentation for 11 lenders), and targeted review reports that had credit elsewhere findings (7 reviews) that SBA conducted in fiscal year 2016. We also interviewed officials and reviewed recent reports from SBA's Office of Inspector General.

To assess the extent to which SBA evaluates trends in lender practices related to the credit elsewhere requirement, we interviewed SBA officials and reviewed documentation for SBA's online portal for loan origination. We also incorporated information from interviews with a nongeneralizable, nonrepresentative sample of 7(a) lenders, which we discuss below.

To obtain lenders' views on the criteria used to determine eligibility for 7(a) loans and other program-related issues, we interviewed SBA staff including from the Office of Capital Access, and representatives of the National Association of Government Guaranteed Lenders; American Bankers Association; Independent Community Bankers Association; and

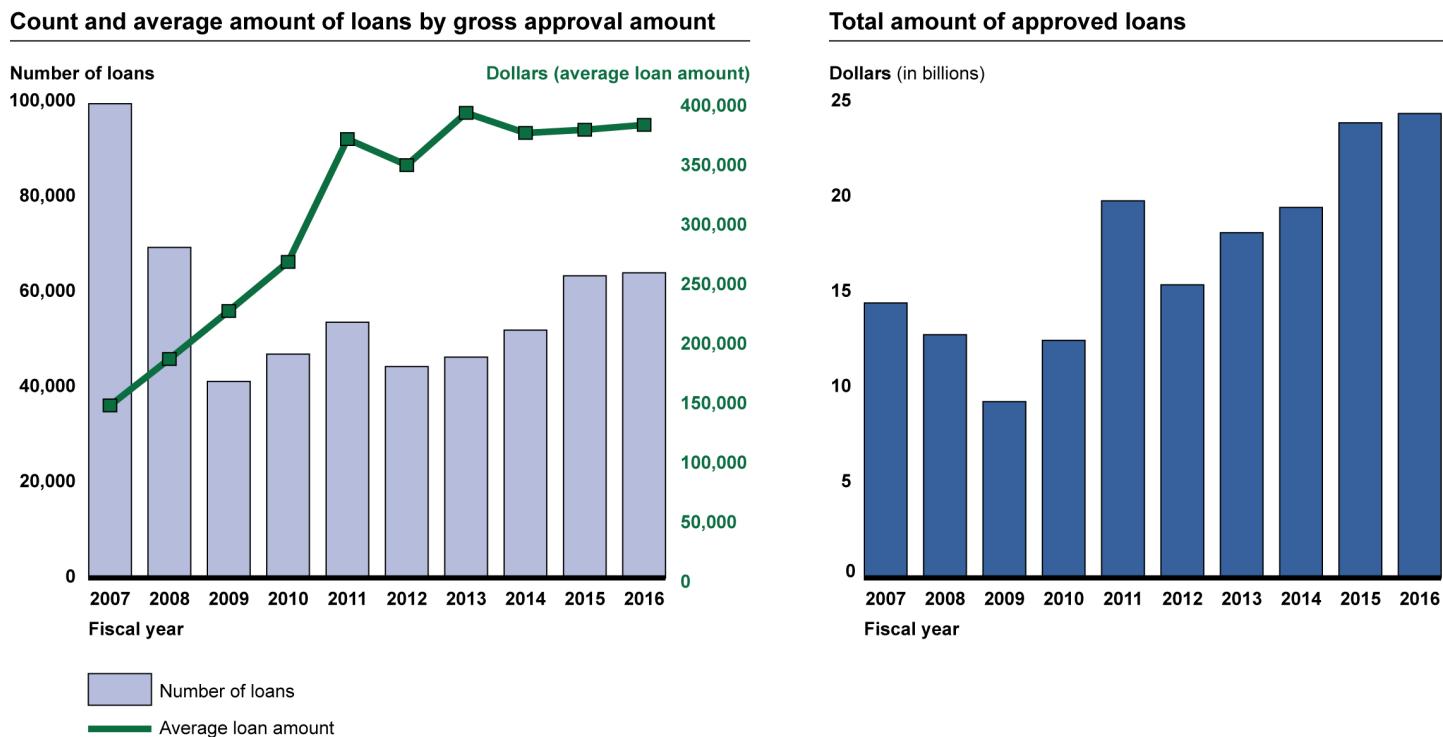
National Federation of Independent Businesses. We also interviewed 11 banks (one bank provided written responses) in order to obtain the lender perspective of credit elsewhere. Nine of the banks were selected by us using a random process that concentrated on larger lenders. These nine lenders selected by us represent about 13 percent of the loans approved and 16 percent of the dollars approved in 2016. In addition, we interviewed two additional banks that represented an industry group – one larger bank and one small bank. Although we partially selected at random, the lenders we interviewed should not be considered generalizable because of the small number.

We conducted this performance audit from August 2017 to June 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Selected Characteristics of 7(a) Lending, Fiscal Years 2007–2016

In this appendix, we provide information on the total amount and number of approved 7(a) loans and the top eight industry sectors receiving 7(a) loans. Data are also presented on fiscal year 2016 loan volume by state and per capita. As shown in figure 6 below, the total amount of approved 7(a) loans decreased during the period associated with the Great Recession (2007 through 2009). From fiscal year 2009 on, the total amount of approved 7(a) loans increased until a decline in fiscal year 2012. During this timeframe, the American Recovery and Reinvestment Act of 2009 and the Small Business Jobs Act of 2010 provided fee relief and higher guaranties. The Small Business Jobs Act of 2010 also provided a temporary increase in Small Business Administration (SBA) Express loan limits to \$1 million (instead of \$350,000). These programs have since expired.

Figure 6: Number, Average Amount, and Total Amount of 7(a) Loans Approved, Fiscal Years 2007–2016



Source: GAO analysis of Small Business Administration data. | GAO-18-421

7(a) Loans by North American Industry Classification System (NAICS) code.

Table 1 shows the largest eight industrial sectors by proportion of the total amount of 7(a) loans approved, using the NAICS code. The combined share of the top eight sectors declined slightly from 85 percent to 80 percent of the total lending from fiscal years 2007 through 2016, with an average of 82 percent. During this period, the Accommodation and Food Services sector had the largest average share of total loan amount at 17 percent, followed by the Retail Trade sector at 15 percent.

Table 1: Share of the Total 7(a) Loans for the Top Eight Industrial Sectors by NAICS Code, Fiscal Years 2007–2016

NAICS code		Fiscal year										Average
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
72: Accommodation & Food Services	Percentage	18	18	15	14	16	16	18	18	18	18	17
44-45: Retail Trade	Percentage	20	18	15	16	15	15	15	14	14	14	15
62: Health Care & Social Assistance	Percentage	9	11	12	12	11	11	11	11	11	12	11
32-33: Manufacturing	Percentage	10	9	12	12	13	12	12	11	10	10	11
81: Other Services (except Public Administration)	Percentage	10	9	8	8	7	7	8	8	8	8	8
54: Professional, Scientific, & Technical Service	Percentage	7	9	9	9	8	8	8	7	7	7	8
42: Wholesale Trade	Percentage	6	6	7	7	8	8	7	7	7	6	7
23: Construction	Percentage	7	6	7	6	5	6	5	6	5	6	6
Total NAICS code	Percentage	85	86	85	84	82	82	83	82	80	80	82

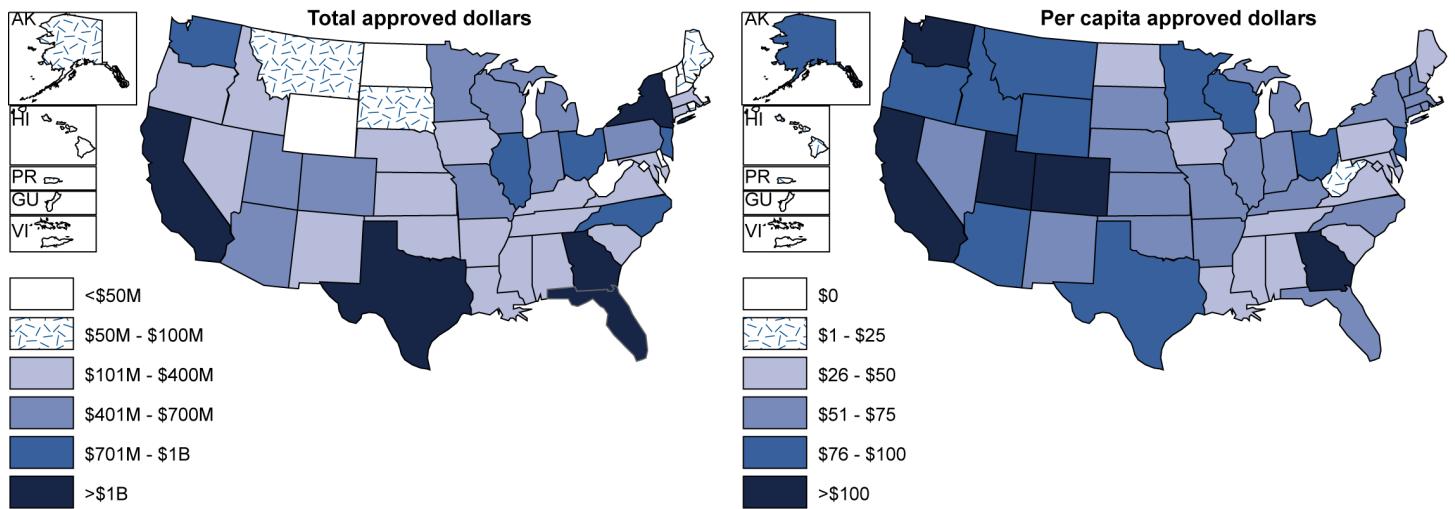
Source: GAO analysis of Small Business Administration data. | GAO-18-421

Notes: North American Industry Classification System (NAICS) codes range from two to six digits and increase in specificity of description as the number of digits increase. We grouped the economic sectors using the first two digits of the NAICS code.

Approved loan amount and per capita dollars by state. As shown in figure 7, California; Texas; Florida; Georgia; and New York received the highest total of approved loan dollars in fiscal year 2016. The average approval amount across all loans was \$380,619. Georgia and Arkansas had the largest average approval amount in 2016. Also, during this period, Utah; Colorado; Georgia; California; and Washington received the highest per capita approved loan dollars.

**Appendix II: Selected Characteristics of 7(a)
Lending, Fiscal Years 2007–2016**

Figure 7: Fiscal Year 2016 Total Approved 7(a) Loan Dollars and Per Capita Approved Loan Dollars by State



Sources: GAO analysis of Small Business Administration data. | GAO-18-421

Appendix III: Information on Borrower Characteristics Based on SBA's Predictive Scores

In fiscal-year 2016, creditworthiness varied widely among 7(a) program borrowers. We analyzed creditworthiness using the Small Business Administration's (SBA) Small Business Risk Portfolio Solution score (predictive score), which ranges from 70 to 300, with 300 indicating the least risky loan.¹ According to SBA, loans with scores above 180 are considered "lower risk," scores between 140 and 179 are considered "moderate risk," and scores 139 and lower are considered "higher risk." There did not appear be differences in score based on the gender of the borrower or the age of the business. While SBA relies on the Predictive Score data to identify lenders that may pose excessive risk to the SBA 7(a) portfolio, the data also provide potential insights related to lender implementation of the credit elsewhere requirement.

- Variation. We found that some 7(a) borrowers were much more creditworthy than others. In 2016, the only year for which we obtained data, the predictive score at origination varied widely among borrowers. In 2016, the scores of borrowers ranged from a low of 91 to a high of 246. However, most scores were between 171 and 203, and the median score was 188.
- Race/ethnicity. We found that there were slight differences in creditworthiness by race/ethnicity, with median scores ranging from 180 to 189 depending on the category. Specifically, loans to African Americans in 2016 had a median score of 180, and loans to Hispanics had a median score of 183. In contrast, loans to whites had a median score of 188, and loans to Asian and Pacific Islanders had a median score of 189.
- Lender size. We found that lenders with larger numbers of SBA loans tended to have slightly more creditworthy borrowers. The top 5 percent of lenders had a median average score of 187, whereas the bottom 75 percent of lenders had a median average score of 182.5. Among the top 5 percent of lenders (with 374 loans per lender on average, collectively representing about 70 percent of the loans approved), the average score ranged from 171 to 195.² Among all

¹According to SBA, the Small Business Risk Portfolio Solution score is a portfolio management credit score that is used by SBA to predict the likelihood of severe delinquency at the loan level. These scores rank loans based on their probability of severe delinquency within a range between 70 and 300. As scores increase for a given set of loans, the probability of delinquency decreases. Also, the predictive score data is one of several components used to identify lenders that may pose a risk.

²The top 5 percent represented 96 lenders, which represented approximately 70 percent of the loans approved in fiscal year 2016.

**Appendix III: Information on Borrower
Characteristics Based on SBA's Predictive
Scores**

lenders, the average score ranged from 116 to 233. However, because many lenders only approved one or two loans in 2016, the average may reflect very few borrowers for that lender, making it difficult to tell whether the scores reflect a real difference between lenders.

Appendix IV: Comments from the Small Business Administration



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

May 17, 2018

Mr. William B. Shear, Director
Financial Markets and Community Investment
U.S. Government Accountability Office
Washington, D.C. 20548

Dear Mr. Shear:

Thank you for providing the U.S. Small Business Administration (SBA) with a copy of the U.S. Government Accountability Office (GAO) draft report titled "*Small Business Loans: Additional Actions Needed to Improve Compliance with the Credit Elsewhere Requirement*" (Draft Report). The Draft Report discusses how SBA monitors lenders' compliance with the credit elsewhere requirement, the extent to which SBA has evaluated trends in lender credit elsewhere practices, and lender views on the credit elsewhere criteria. SBA generally agrees with GAO's recommendations, but has the following comments with respect to the recommendations:

- (1) *The Administrator of SBA should require reviewers to consistently document their assessments of a lender's policies and practices.*

SBA has instructed reviewers to document their assessments of a lender's policies and practices. Going forward, SBA will take necessary steps to ensure that reviewers are consistent in documenting their assessments of lenders' policies and practices for complying with the credit elsewhere requirement.

- (2) *The Administrator of SBA should use its on-site and off-site reviews to routinely collect information on lenders' use of credit elsewhere criteria as part of its monitoring of lender practices related to the credit elsewhere requirement.*

SBA has been collecting information on lenders' use of the credit elsewhere criteria for the reviews it conducts virtually (formerly referred to as "off-site reviews"). Going forward, SBA will also collect information on lenders' use of the credit elsewhere criteria when conducting reviews that include loan file reviews, whether performed at the lender's location (formerly referred to as "on-site reviews") or virtually.

- (3) *The Administrator of SBA should analyze information on lenders' use of credit elsewhere criteria obtained from its reviews to identify lenders that may be at greater risk of noncompliance and to inform its selection for further review for credit elsewhere compliance.*

SBA currently incorporates several data elements and information from prior reviews, including Findings and deficiencies related to credit elsewhere, to inform its selection of lenders for review. SBA will incorporate data on lenders' use of the credit elsewhere

Mr. William B. Shear
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criteria obtained from reviews to determine whether further review of that lender is warranted.

In addition, SBA has the following concerns with some of the language in the Draft Report:

On the GAO Highlights page, in the first paragraph of the Draft Report, GAO states that SBA “has largely delegated authority to lenders to make 7(a) loan determinations for those borrowers who cannot obtain conventional credit at reasonable terms elsewhere.” While SBA has delegated the determination of whether the applicant has credit available elsewhere to participating lenders that have been granted delegated authority, this is not the case for applications submitted to SBA on a non-delegated basis. Delegated Lenders are required, when requesting an SBA loan number, to certify to having met the credit elsewhere requirement and to have documentation to substantiate the credit elsewhere determination in the loan file. With respect to applications submitted to SBA under non-delegated processing, SBA makes the final determination as to whether the applicant has credit available elsewhere as part of its overall decision of whether to approve the request to guarantee the loan.

In the same paragraph, GAO also states that “[t]o monitor lender compliance with the ‘credit elsewhere’ requirement SBA primarily uses on-site reviews conducted by third-party contractors.” This statement is not entirely accurate. As SBA explained to GAO in its March 23, 2018 technical comments to GAO’s Statement of Facts for this review (SBA’s Technical Comments), the Agency reviews lender files in multiple risk-based review approaches, including targeted reviews and ad hoc virtual file reviews. In addition, Improper Payments Elimination and Recovery Act (IPERA) and quality control reviews, which include credit elsewhere among other issues, are performed in SBA’s Loan Guaranty Processing Center at time of loan approval and at the National Guaranty Purchase Center at time of guaranty purchase. Thus, SBA does not primarily use on-site reviews to monitor lender compliance with the credit elsewhere requirement. With respect to GAO’s statement in the Draft Report that the on-site reviews are “conducted by third-party contractors,” SBA also clarified this issue in its comments provided to GAO on March 23, 2018. On page 2 of SBA’s Technical Comments, we stated that SBA provides oversight on every on-site review and an SBA employee is present as a subject matter expert on every review, regardless of the type of review. Further, all reviews are overseen by an SBA employee, and primary responsibility for oversight is the Agency’s, not the contractors’.

On page 2 of the Draft Report, GAO states that “... SBA guarantees loans made by commercial lenders to small businesses for working capital and other general business purposes.” Generally, working capital is not the primary purpose for SBA-guaranteed loans.

On page 15 of the Draft Report, in paragraph 2, GAO states “[a]n SBA official stated that off-site reviews followed the same procedures in fiscal year 2017 and that the agency planned to use the same procedures for these reviews in the future.” SBA also clarified this issue for GAO in its March 23, 2018 Technical Comments by stating that the Office of Credit Risk Management is constantly implementing improvements to its review processes and procedures. SBA reiterates

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that it routinely evaluates and revises its review processes and procedures to strengthen the effectiveness of SBA's oversight.

On page 18 of the Draft Report, Footnote 34 states that SBA did not provide documentation of lenders' responses for two of six lenders. On February 15, 2018 SBA provided a flash drive to GAO with responses for the two lenders. We received confirmation of receipt of the flash drive by GAO on February 20, 2018. GAO subsequently confirmed receipt of the documentation for the corrective action assessments for the last two lenders on March 20, 2018.

Finally, on page 23 of the Draft Report, GAO states, “[t]he new guidance states that lenders must consider nonfederal sources related to the applicant, including the liquidity of owners of 10 percent or more....” In SBA’s Technical Comments on March 23, 2018, SBA advised GAO that it was in the process of revising this guidance. SBA issued Policy Notice 5000 – 17057, effective on April 3, 2018, which changed this requirement from owners of 10 percent or more to owners of 20 percent or more.

Thank you for giving SBA the opportunity to comment on GAO’s draft report, “*Small Business Loans: Additional Actions Needed to Improve Compliance with the Credit Elsewhere Requirement*” and for taking SBA’s comments into consideration.

Sincerely,



William M. Manger, Jr.
Associate Administrator
Office of Capital Access

Appendix V: GAO Contact and Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition to the contact named above, Harry Medina (Assistant Director); Janet Fong (Analyst in Charge); Benjamin A. Bolitzer; Gita DeVaney; David S. Dornisch; Amanda D. Gallear (intern); Marc W. Molino; Jennifer W. Schwartz; and Tyler L. Spunaugle made key contributions to this report.

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