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The Future Of The Small Business Administration And their Lending Program

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THE FUTURE OF THE SMALL BUSINESS ADMINISTRATION AND THEIR LENDING PROGRAMS

by

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This independent study submitted by Gregory D. Shirley in partial fulfillment of the requirements for the Degree of Master of Business Administration from the University of North Dakota is hereby approved by the Faculty Advisor under whom the work has been done. This independent study meets the standards for appearance and conforms to the style and format requirements of the Graduate School of the University of North Dakota.

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ABSTRACT

The Future of the Small Business Administration
and Their Lending Programs

Gregory D. Shirley

The University of North Dakota Graduate Center, 1989

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The SBA is one of many federal agencies that are being scrutinized as to the use of the funds they receive from the Federal Government. The SBA's loan programs have been criticized for not being cost effective. This paper will examine the types of loans the SBA makes, the cost of these loans and the procedures for determining who obtains the loans. There are major flaws in the way the SBA manages its current loan portfolio. These flaws have resulted in an above average rate of default on SBA loans. Chapter III examines these faults. Chapter IV deals with solutions to the SBA's problems. These solutions are divided into three parts. The first recommendation suggests ways the SBA can better utilize their current resources and programs. It also suggests changes in policy and management styles to improve current practices. The second part of the solution deals with changes Congress has to make in the current laws. These changes include increasing fees, lowering the SBA's

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exposure to loan losses and eliminating unnecessary and costly programs. The third part of the solution recommends ways the SBA can reduce their total risk in further loan portfolios. These recommendations, if followed, would greatly improve the efficiency of the SBA.

CHAPTER I

INTRODUCTION TO THE SBA

The Small Business Administration was created in 1953 with the passage of the Small Business Act. The Small Business Act stated that the purpose of the SBA would be to

> aid, counsel, assist and protect the interests of small business concerns in order to preserve free competitive enterprise.[1]

The SBA was established to help the 4.5 million (1960) small businesses [that] play a distinct role in the national economy. These small businesses operate at a distinct disadvantage compared with larger businesses.[2] That 4.5 million small businesses had grown to an estimated 14 million businesses in 1986.[3]

The SBA currently has only 4,000 employees to handle these 14 million businesses' concerns. These 4,000 employ-

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[1] <u>President's Private Sector Survey on Cost Control: Report On the Small Business Administration</u>, by J. Peter Grace, Chairman (U.S. Government Printing Office: Washington, D.C., 1983), p. 2.

[2] <u>Federal Handbook for Small Business</u>, Small Business Administration, (U.S. Government Printing Office: Washington, D.C., 1960), p. 1.

[3] Rodger Thompson, "Small Business," <u>Editorial Research Reports</u>, Vol I No. 23, (June 19, 1987), p. 304.

ees are spread throughout 104 district offices, 10 regional offices and the head office in Washington, D.C. There is an SBA district office in all fifty states, Washington D.C., Guam, Puerto Rico and St. Thomas in the Virgin Islands.[4]

The SBA as mandated by Congress, defines a small business as "one that is independently owned and operated and not dominant in its field." The SBA has set up further restrictions based on how many employees a firm has and its total sales volume in dollars. They use different standards for different types of businesses.[5]

For a small business involved in manufacturing, to qualify for a loan, they can employ no more than 500 to 1,500 people depending on the type of product manufactured. Wholesalers are limited to 100 employees. Services industry businesses are restricted to annual sales of under $3.5 to $14.5 million. General construction receipts have a cap at $9.5 to $17 million with special trade construction limited to $7 million. Agricultural businesses have limits of $.5 to $3.5 million, again, depending on the industry.

The SBA also limits the use of the loans. No loans will be given to any business that is involved in the creation or distribution of ideas or opinions (newspapers or

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[4]John Ganly, Diane Sciottara, and Andrea Peddsky, editors, "Information, Resources and Services: Small Business Administration," Small Business Sourcebook, pp. 376-381.

[5]U.S. Small Business Administration, Your Business and the SBA, Office of Public Communication, booklet OPC-2, February 1987, p.2.

magazines). Businesses engaged in speculation or invest in rental real estate are also ineligible to receive SBA loans.[6]

The SBA is involved in a number of programs to help the small businessman. Their biggest program would be guaranteeing loans to small business. The SBA guaranteed over 2 billion dollars worth of loans in fiscal year 1983.[7] The SBA also has a direct loan program and a disaster loan program. These programs are administered directly from the offices in Washington, D.C.[8]

The SBA plays an important role in helping small businesses raise venture or risk capital as well. They do this through over 500 Small Business Investment Companies (SBIC). The SBIC's are privately owned companies but are licensed, regulated and receive financial assistance from the SBA.[9] SBIC's are limited as to how much stock (less than 50%) they can own in any company they invest in. They can't be self-serving investments or acquire control of the business that is being financed. To get an SBIC license a detailed plan of proposed operation and organization must be submitted to the SBA. This plan must include how the initial capital will be raised. The SBA places further restrictions on the

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[6]U.S. Small Business Administration, Business Loans From the SBA, Office of Public Communications, booklet OPC-6, September 1986, pp. 5-6.

[7]P.P.S.S.C.C., p. i.

[8]U.S. SBA, Your Business and the SBA, pp. 6-9.

[9]Ibid., p. 9.

size of a business SBIC's can invest in and how much an SBIC can invest in any one business (not more than 20% of paid in capital). In 1958 a company needed $150,000 in paid-in capital to get an SBIC license. It could then acquire from the SBA $150,000 in the form of a subordinate debenture. The SBIC could also borrow up to 50 percent of its statutory capital from the SBA. In 1963, Congress put a limit of $4 million on the amount a SBIC could borrow. They also increased the subordinate amount to $700,000. That meant an SBIC with $800,000 of private capital could qualify for $4.7 million from the SBA. This amount was increased to $10 million in 1967 if a SBIC had over $1 million in paid-in capital. The SBIC's also have unique tax advantages, including a 100 percent deduction for dividends received and liberal deduction rules for losses incurred.[10]

The first SBIC to be established was First Midwest Capital Corp of Minneapolis, in March of 1959. It consisted of 32 individual investors and the Northwestern National Bank. They started with $315,000. They established an investment level limit of about $500,000 for their SBIC in the 60's.[11] That limit has changed over the years. For FY 1986 the average equity financing for a SBIC was $274 million. The SBIC's helped finance 1,768 small businesses in

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[10]Stanley M. Rubel, <u>How to Raise and Invest Venture Capital</u>, Chapter 15, pp. 217-228.

[11]EBIT, pp. 199-204.

1986.[12]

The SBA also plays an important role in helping to educate the small business owner on how to run his business more effectively. They accomplish this through their Small Business Institutes (SBI's) and their Small Business Development Centers (SBDC's).[13]

The SBA offers managerial courses through local educational institutions and local chambers of commerce. These courses range from prebusiness seminars to classes on planning, organizing and controlling a business.[14] The SBA will work with local businessmen to develop specific seminars of local interest, to help solve any problems the businessman might have. The SBA has hundreds of specific reports available to help the small businessman deal with special problems or situations he has encountered.[15]

The SBA has been assigned the responsibility for helping small business get government contracts. They also work with minorities and women, who traditionally have a diffi-

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[12]U.S. Small Business Administration, SBIC Digest, Part I, Annual Financing Summary, (SBA Investment Division), April 1987, pp. 1-3.

[13]U.S. Small Business Administration, Annual Report 1984, Vol. I (U.S. Government Printing Office: Washington, D.C.), p. 40.

[14]Ivan C. Elmer, A Strategy Handbook: Helping Small Business through Chamber of Commerce, (office of Chamber of Commerce Relations: Washington, D.C.), p. 21.

[15]U.S. SBA, Your Business and the SBA, pp. 11-13.

cult time developing their own small business.[16]

The SBA helps the small businessman in other ways as well. The SBA was responsible for developing the Service Corps of Retired Executives (SCORE) and Active Corps of Executives (ACE) programs. These programs are aimed at helping the small businessman overcome tough management problems by providing him with individual counseling from someone who has been there before.[17] All SCORE and ACE participants are volunteers. They volunteer their time and expertise at no cost to the business or the SBA. The commitment these volunteers make to help a business can last for months or even years. These volunteers have helped hundreds of small businesses get started or helped solve their business problems.

One of the more recent developments at the SBA was the addition of "The Office of Advocacy," created in 1976.[18] The Chief Council for Advocacy is appointed by the President and confirmed by the Senate. His chief role is to

> "represent small business interest before other federal agencies and to ensure that small business would continue to be the cornerstone of our free enterprise system."

The office of advocacy also conducts economic studies and statistical research for small business. It provides information on small business issues to small business. The

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[16]Ibid., p. 5.

[17]Ibid., pp. 10-11.

[18]Ibid., pp. 3-4.

Office of Advocacy also "serves as a conduit through which small business can make suggestions and policy criticisms." The Chief Council for the Office of Advocacy is responsible for generating the annual President's Report on the State of Small Business.[19]

As the preceding information shows, the SBA provides a vital service to the 14 million small businesses in this country. The SBA's two major missions would be to provide access to capital for the small businessman and to provide the education and guidance to help the small businessman use that capital to its fullest potential.

The following chapters will deal with those two missions. Chapter II will examine how the SBA provides access to capital. Chapter III will look at how the SBA manages the two missions. Chapter IV will suggest ways to better utilize the tools the SBA currently has and changes it should make to improve the current programs.

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[19]U.S. SBA. Annual Report 1984, Vol. I, p. 43.

CHAPTER II

HISTORY OF THE SBA'S LENDING PROGRAMS

The Guaranteed Loan Program

The SBA guarantees over 2 billion dollars worth of small business loans a year. They do this through the 7(a) program and the network of local banks across the country.[1] For a business to be eligible for a guaranteed SBA loan, the business has to try and find financing from another source first. If the business is not successful, it can apply for an SBA loan through its local bank. The bank screens the loan application and forwards it to the SBA district office. If the SBA approves the loan, the businessman negotiates the terms of the loan with his local bank. The local bank provides the loan and the SBA guarantees up to 90% of the principal of the loan and all of the interest.[2] Congress set the 90% guarantee rate in 1981.[3] The term of a guaranteed loan runs from 5 to 25 years. The interest rate is usually only 2 percentage points over the prime rate.

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[1]P.P.S.S.C.C., pp. 4-5.

[2]U.S. Small Business Administration, Business Loans from the SBA, Office of Public Communications. OPC-6 September 1986, p. 2.

[3]P.P.S.S.C.C., p. 11.

Without the loan guarantee, the interest rate might run 5 or more percentage points over prime. The SBA has a $500,000 cap on the amount it will guarantee.

The SBA also requires that sufficient assets be pledged as collateral to secure the loan. In lieu of collateral the SBA will accept personal guarantees or liens on personal property.[4]

There are certain character and credit requirements that each applicant must meet. According to the SBA each applicant must be of good character, demonstrating sufficient management expertise and be committed to running a good, successful operation. The business must have enough reserve capital to operate on a sound financial basis and show that past or probable future earnings will be sufficient to repay any loans.[5]

Currently the SBA has over 9.2 billion dollars in outstanding guaranteed loans to 110,000 businesses.[6] For 1984 the SBA guaranteed 18,368 loans worth 2.6 billion dollars.[7] They guaranteed 3.2 billion in 1988.[8] The delinquency rate for SBA guaranteed loans was 9.1% in 1984.[9]

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[4]U.S. SBA, "Business Loans from the SBA," pp. 3-4.

[5]EBIT, p. 4.

[6]P.P.S.S.C.C., p. 6.

[7]U.S. SBA, Annual Report 1984, Vol. I, p. 26.

[8]Joan C. Szabo, "Small-Business Update - SBA Would Alter Programs," Nations Business, May 1988, p. 14.

[9]U.S. SBA, Annual Report 1984, Vol. I., p. 28.

This is four times higher than the delinquency rate experienced by banks without guarantees.[10]

To speed up the loan approval process and get more direct bank involvement with the lending process, the SBA has started two new programs. The Certified Lender Program (CLP) allows the SBA to guarantee a loan package, submitted by the banks, in three days. This is possible because the banks provide the necessary financial analysis and presents a complete loan package to the SBA. There are currently 500 banks participating in the CLP.[11]

The Preferred Lenders' Program (PLP) allows banks with a proven SBA track record to make SBA guaranteed loans without the SBA's approval.[12] These programs will put more pressure on the banks to make good loans and should also help the SBA improve its loan portfolio.

Besides improving the SBA loan portfolio, the CLP or PLP should reduce the amount of time a SBA loan officer spends processing a loan. It currently takes 8 to 20 hours without a certified loan and only 2 to 8 for a CLP loan.[13]

The Direct Loan Program

The SBA's direct loan program is reserved for special

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[10]P.P.S.S.C.C., p. 21.

[11]EBIT., p. 9.

[12]EBIT., p. 4.

[13]EBIT., p. 10.

situations and the loans are limited to $150,000. These loans are administered directly through the SBA office in Washington, D.C.[14] For fiscal year 1984 the SBA had 2,181 loans outstanding, worth almost 138 million dollars.[15]

Since these loans are available to only applicants unable to secure an SBA guaranteed loan,[16] they have experienced a higher default rate than the guaranteed loans. The average lose rate for direct loans is 12.35% versus 9.5% for the guaranteed loans.[17]

The direct loan program is also more labor intensive to operate. Currently there are 351 people processing 39,000 direct loans compared to the 716 people processing 110,000 guaranteed loans. The SBA estimates that direct loans are 200% more costly to administer than guaranteed loans.[18] This imbalance will get worse as more guaranteed loans are processed through CLP and PLP. The cost of servicing and liquidating direct loans is also about 50% higher on average than a guaranteed loan.

Disaster and Other SBA Loans

The SBA has become a lender of last resorts in recent

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[14]U.S. SBA, "Business Loans from the SBA," p. 2.

[15]U.S. SBA, Annual Report 1984, Vol. I., p. 26.

[16]U.S. SBA, "Business Loans from the SBA," p. 2.

[17]P.P.S.S.C.C., p. 8.

[18]EBIT., p. 8.

years. The SBA is currently required to provide loans for physical losses and economic losses due to national disasters. These loans are available to home owners, renters, non-profit organizations, farms and businesses, both large and small.[19]

Disaster loans become available to just about anyone if the President of the United States declares that a major disaster has occurred. The SBA administrator may also declare that an SBA disaster has occurred and make SBA disaster loans available. To be eligible for a disaster loan an applicant has to be denied credit elsewhere. These loans are usually available below the prime rate and are tied to the cost of money to the U.S. Government.[20]

The loans are divided into two major categories: business loans and personal loans. The business loans are subdivided into physical disasters or economic injury disaster loans. Personal loans are subdivided into home loans or personal property loans.

The SBA has funded 10 billion dollars in direct disaster loans since 1953. They have had to write off 300 million or 3%. Of the 6.5 billion dollars in outstanding disaster loans on the books in 1981, over 3 billion were to

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[19]U.S. SBA, "Business Loans form the SBA," p. 2.

[20]P.P.S.S.C.C., p. 32.

farmers, all of these since 1977.[21] Congress decided in 1981 to handle all farm related disasters through the Federal Farms Home Administration.[22]

The SBA estimates that 85% of their disaster loans are flood related. Over 80% of these losses could have been covered by insurance. These flood losses increase the cost of the SBA as well as increase the cost for the National Flood Insurance Program operated by the U.S. Government.[23]

For FY 1984, there were 42 SBA and 25 presidential disasters declared. The SBA approved 13,000 loans totaling 300 million dollars. This was down from FY 1981's 400 million dollars.

Congress made four changes in the disaster loan program in 1984. Congress put the SBA back into farm lending, lowered the interest rates and added two new disaster programs (PIK and Currency Devaluation).[24] These changes resulted in the SBA subsidizing more businesses, with less resources, and a mandate from Congress to lower its costs.

The SBA's disaster loan program was put under further pressure by the drought of 1988. The drought not only hurt farmers (they can't apply) but also the businesses that are dependent on the farmer (farm implement dealers, grain

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[21]P.P.S.S.C.C., p. 35.

[22]EBIT., p.34.

[23]EBIT., p. 35.

[24]U.S. SBA, Annual Report 1984, p. 25.

elevators, and seed suppliers). These businesses that suffered "economic injury" losses are eligible to apply for SBA Economic Injury Disaster Loans (EIDL's). That includes just about all businesses in the rural Midwest. These loans carry an interest rate of only 4%. The loans are to replace working capital lost due to reduced business from the drought. These loans totaled $4.6 million in North Dakota alone by the end of 1988. The SBA expects that they will receive many more applications before the April 12, 1989 deadline.[25]

The Disaster Loan Program continues to be a catchall loan program for the Federal Government. Only about one-third of the money spent goes to small business and the majority of that could be covered by insurance.

Loans to Small Business Investment Companies

SBIC's are privately owned companies that help finance small businesses with either direct loans using the business assets as collateral or as an equity investment (common or preferred stock).[26] These private companies are licensed, regulated and receive financial assistance from the SBA.

The SBIC's use a combination of their own capital and

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[25]Stephen I. Lee "SBA Drought Loans Draw Fire," Grand Forks Herald, 24 December 1988.

[26]Robert Grey, Heated Debates Over the SBA," Nations Business, June 1986, p. 18.

funds borrowed from the SBA to form their capital base.[27] From 1973 until 1986, SBIC's received their capital by selling debentures to the Federal Financing Bank. The SBA guaranteed these debentures. The Federal Financing Bank gets its money by issuing its own obligations in the financial markets or to the United States Treasury.[28] For fiscal year 1985 SBIC's received SBA guarantees totaling 250 million dollars. Starting in the 2nd quarter of 1986, the SBIC's left the Federal Financing Bank system. On September 20, 1986 they had their first private sector funding. This leverage is still guaranteed by the SBA.[29]

To obtain an SBIC license from the SBA, an organization must have suitable financial resources and management experience for providing high-risk liquid financing. A potential SBIC has to also show that there is a need for their services in the area they plan to locate in. The SBA does a thorough check of each applicant before a license will be granted.[30]

SBIC's are for-profit companies and do a good job at protecting their investments. They usually will help a struggling small business with management assistance if needed.

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[27]U.S. Small Business Administration, SBIC Digest, October 1987, p. 1.

[28]U.S. SBA, Annual Report 1984, p. 30.

[29]U.S. SBA, SBIC Digest Part I, p. 6.

[30]U.S. SBA Annual Report 1984, pp. 30-31.

Just to make sure the SBIC's are protecting their investments, the SBA requires the SBIC's to make annual reports. If unsound financial practices are disclosed the SBA will take action.[31]

The SBIC's have helped over 70,000 businesses since they were founded in 1958. Among the businesses that have received funding from SBIC's are Apple Computers, Federal Express and Cray Research.[32]

Congress enacted the Small Business Investment Act in 1958 because they felt there was a gap in the current financial markets. Because of that gap, the needs of the small businessman were not being fulfilled. Congress declared that

> "to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long term loan funds which small business concerns need for the sound financing of the growth, expansion and modernization, and which are not available in adequate supply."[33]

The SBA makes long term loans to the SBIC's on a ratio of between 3 or 4 government dollars to every private SBIC dollar.[34] The SBA charges an interest rate of 1/8 of 1%

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[31]Ibid., p. 31.

[32]Jay Pinegan, "Cleaning House," INC, June 1986, p. 33.

[33]P.P.S.S.C.C., p. 53.

[34]Robert Grey, "Capital Crunch for SBIC's," Nations Business, September 1986, p. 14.

over their cost of funds plus a handling charge of .125%.[35]

For fiscal year 1986 283 SBIC's made 2,675 loans to small business totaling 475 million dollars. Approximately 70% of this financing was in the form of an equity interest. There were also 335 SBIC's reporting losses of 64.5 million dollars on an investment of 3.3 billion dollars. This is equivalent to a loss rate of 1.98%, which is in line with what most private banks sustain.[36]

The SBIC program seems to be one of the more successful, cost effective programs the SBA has to offer. SBIC's continue to help more businesses each year, most of them new businesses.[37] With a more prudent use of its auditors, the SBA could reduce the cost to the federal government even further, making the SBIC program even better.[38]

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[35]P.P.S.S.C.C., p. 56.

[36]U.S. SBA, SBIC Digest, Part I, pp. 1-2.

[37]U.S. SBA, SBIC Digest Part I, April 1987, p. 4.

[38]U.S. Small Business Administration, Semiannual Report of the Inspector General, October 31, 1987, p. 4.

CHAPTER III

PROBLEMS FACING THE CURRENT LENDING PROGRAMS

There have been a wide range of ideas generated through the media on what to do with the SBA's loan programs. Some people think the whole SBA should be eliminated and parts of it absorbed into the Commerce Department.[1] At the other end of the spectrum, the White House Conference on Small Business listed as one of its possible priorities making the SBA head, a Cabinet-level position.[2] Opposition from the U.S. Chamber of Commerce and other small business activists kept the SBA from being merged into the Commerce Department.[3] What appears to be happening is a compromise position for the SBA. Charles L. Heatherly, then acting administrator, said that his goal was to make the SBA "more self-sufficient." He wanted to do this through increased user fees and improvements in the loan guarantee program. He also

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[1]Robert T. Grey, "SBA Cuts Pushed to the Back Burner," Nations Business, September 1986, p. 16.

[2]U.S. Small Business Administration and the Office of Private Sector Initiatives, A Tribute to Small Business, 1987, p. 27.

[3]Robert T. Grey, "Heated Debate Over SBA," p. 18.

wanted to eliminate or greatly reduce direct and disaster loans.[4] That is what the President's Private Sector Survey on Cost Control (P.P.S.S.C.C.) recommended. That report listed 17 recommendations (see table 3.1, pp. 20-21) to improve the efficiency of the SBA, raise its revenue or lower its costs.[5] Some of these recommendations are being implemented but most have gotten bogged down in Congress. President Reagan's 1989 budget for the SBA included ideas that would have been good for the SBA but they were eliminated once the budget reached Congress. In fact, instead of reducing the SBA programs, Congress added even more programs for the SBA to administer.[6]

The problem of Congress constantly requesting changes in the SBA's programs is only one of a number of problems facing the SBA. Other problems include the quality and types of loans made and how the loans are monitored and collected. The SBA must come to grips with the economic and geographic risks they face when making loans.

The Nature and Quality of SBA Loans

The President's Private Sector Survey on Cost Control showed that the quality of the SBA's loan portfolio started

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[4]World News Digest "Plan to Eliminate SBA Dropped," 1986 Facts on File, August 29, 1986 p. 640.

[5]P.P.S.S.C.C. pp. 80-81.

[6]Joan C. Szabo, "SBA Would Alter Programs," p. 14.

Table 3.1 Recommendations for Improving the SBA From the Presidents Private Sector Survey for Cost Control

Recommendations	Authority	3 Year Savings
1) Reduce the maximum guaranty and limit the rate of interest purchased under a guaranty.	Congress	89.4 Million
2) Eliminate direct business loans.	Congress	22.6 Million
3) Designate banks to liquidate problem loans.	SBA	9.1 Million
4) Utilize private collection services to work charged-off loans.	Congress	118.5 Million
5) Encourage participation in the CLP and expeditiously implement the PLP.	SBA	7.2 Million
6) Increase the loan guaranty fee.	SBA	60.3 Million
7) Discontinue making farm loans and transfer existing portfolio to FmHA.	Congress	
8) Discontinue disaster loans for insurable but uninsured flood related losses.	Congress	62.9 Million
9) Discontinue disaster loans to businesses and individuals with credit available elsewhere.	Congress	3.0 Million

Table 3.1 Recommendations for Improving the SBA From the Presidents Private Sector Survey for Cost Control

Recommendations	Authority	3 Year Savings
10) Exclude permanently farmers from SBA's diaster loan program.	Congress	Not Quantified
11) Reduce the SBA Surety Bond Guaranty maximum guaranty.	SBA	29.7 Million
12) Increase fee to contractors in the Surety Bond Guaranty Program	Congress	16.5 Million
13) Charge user fee on SBIC borrowings.	Congress	4 Million
14) Modify deposit schedule for payments and eliminate delays.	SBA	4.5 Million
15) Limit backdating of payments.	SBA	.3 Million
16) Combine select regional offices.	SBA	1.8 Million
17) Improve monitoring of district office loans and processes, better train SBA lending officers, improve timeliness of information, allow bad debts to be reported to credit bureaus.	Congress and SBA	Not Quantified

to deteriorate around 1980. A contributing factor to that loan deterioration was the emphasis placed on increasing loan volume in 1980. [7] This increased loan volume at a time of high interest rates and the recession that followed, caused the SBA's portfolio of loans to show a marked increase in loans 60 days past due and those that had to be liquidated. The chart below shows this increase.[8]

FiscalYear	% of Loans In Trouble		
	Total	60 Days past	In Liquidation
1979	11.3	3.6	7.7
1980	13.8	5.4	8.4
1981	15.2	5.4	9.8
1982	19.6	7.3	12.3

The SBA has reduced the percentage of bad loans from a high of 19.6% in 1982 to under 10% for 1986.

The reasons for defaults and past due accounts are many. Besides those reasons mentioned above, who receives a loan and for what purpose can affect the quality of a loan. An Office of Management and Budget study in 1985 found that many SBA loans went to car washes, bars and restaurants in areas that already had plenty of those types of businesses.[9] This problem is compounded by the loan process. Since the

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[7]World News Digest, "Plan to Eliminate SBA Dropped", <u>1986 Facts on File</u>, August 29, 1986, p. 640.

[8]P.P.S.S.C.C. p. 9.

[9]Jay Pinegan "Cleaning House," pp. 33-34.

banks have very little risk, they don't have to do as thorough a job of evaluating the loan applicants as they should. If the bank had more at stake, they would work harder at making better loans.

The P.P.S.S.C.C. looked at this problem and recommended 2 remedies. The first was an annual review of the banks making SBA loans, especially those banks with problem loans. If the review showed that a particular bank made more than their share of bad loans, the SBA could restrict or eliminate that bank from making further loans. Since SBA loans are quite profitable for the banks, this should encourage the banks to evaluate potential borrowers with a more discerning eye. The other recommendation the P.P.S.S.C.C. wanted to implement was lowering the amount of the loan the SBA would guarantee from the current 90% to a more realistic 75%.[10] At the 75% guarantee rate, the banks would have much more to lose.

The SBA also has to look at the nature of its loans. Currently the SBA is required by law to make loans to farmers, flood victims and other disaster affected persons. Congress should pass legislation requiring the SBA to make loans to only legitimate businesses for legitimate business purposes. Let the Farmers Home Administration make loans to farmers. After all, over 70% of the FmHA field personnel have farm related backgrounds or education. The SBA field

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[10]P.P.S.S.C.C., p. 21.

personnel have almost none.[11] The SBA should also eliminate disaster loans to insurable flood victims. Currently 85% of all disaster loans are flood related. The majority of these losses could be covered by purchasing insurance from the National Flood Insurance Program.[12]

Monitoring & Collecting SBA Loans

How the SBA loans are monitored also affects the number of problem loans the SBA encounters. Currently the person who makes the loan does not service, monitor or collect the loan. This makes no one accountable for monitoring the loan. This breakdown in accountability is hindered further by the way the SBA monitors its past due accounts. Often, when a loan is 30 or 60 days past due, the officer in charge does not receive the list until five or six weeks after the fact.[13] By the time the SBA knows it has a past due loan, the business may be too far gone to be helped. If the SBA is to use the resources it has to the fullest, it has to have up to date information. Charles Bahr in a speech on the "Seven Deadly Signs of Sin" emphasized the importance of watching for signs of trouble. In today's rapidly changing business climate, companies can fall into trouble very

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[11] P.P.S.S.C.C., p. 28.

[12] P.P.S.S.C.C., pp. 35-36.

[13] P.P.S.S.C.C., p. 22.

quickly.[14] The SBA should develop a list of things to watch for and train their loan officers how to spot trouble early. They also have to develop the means to get this information to the proper people in a timely manner.

Other ways to improve loan quality would include increasing the "penalty" for not making loan payments on time. The present law forbids the SBA from reporting delinquent loans to credit bureaus. This certainly reduces the incentive to make loan payments on time. The way the SBA collects delinquent loans also favors the delinquent borrower. With very few people trained to collect delinquent debts, the SBA makes little or no effort to collect delinquent debts. The SBA should not even be in the bad debt collection business. The banks that make the loans would be the logical choice to collect the bad loans. Most large banks have collection departments. Even smaller banks have an advantage over the SBA because they work with the borrower on a day to day basis. If Congress would change the law to make the banks responsible for collecting bad loans or at least let the SBA hire private collection agencies, a substantial amount of money could be recovered. The banking industry experiences a recovery rate of about 30%, the SBA only collects about 10%.[15]

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[14] L. Charles Bahr, "Sick Companies Don't Have to Die," Vital Speeches of The Day, September 1988 pp. 685-688.

[15] P.P.S.S.C.C., pp. 10-12.

Geographic and Economic Risk

Another area the SBA has to examine when they make loans is the effect of geographic and economic risk that the potential loans represent. In the SBA's report to the President for 1987, they list the number of business failures by region (see table 3.2, p. 27). When comparing the number of business failures region by region, the importance of the geographic differences becomes apparent. The highest percentage increases in bankruptcies occurred generally in states adversely affected by poor conditions in agriculture or resource extraction industries. These regional differences can be dramatic. From 1985 to 1986, region I (CT, ME, MA, NH, RI, VT) experienced an 11.3 percent drop in bankruptcies. Region VI (AK, LA, NM, OK, TX) showed a 35.4% increase in bankruptcies.[16] The SBA has to be aware of these differences. If they don't monitor economic conditions region by region they will experience an unnecessarily high number of bad loans.

The SBA should also weigh the ability of a company to get a loan with what the economy looks like in the near future. A first time business owner starting a new business on an eve of a recession will have an extremely hard time making it (see table 3.3, p. 28). The SBA should also look at the type of business applying for a loan and determine

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[16]U.S. Small Business Administration, "The State of Small Business: A Report of the President," U.S. Government Printing Office, 1987, pp. 8-30.

Table 3.2 Number of Bankruptcies By SBA Region

	1985	1986	% Change
Region I CT,ME,MA,NH, RI,VT	1,312	1,164	-11.3
Region II NJ,NY	2,589	3,673	2.3
Region III DE,DC,MD,PA, VA,WV	4,302	4,158	-3.3
Region IV AL,FL,GA,KY, MS,NC,SC,TN	9,089	9,904	9.0
Region V IL,IN,MI,MN, OH,WI	13,029	12,250	-6.0
Region VI AR,LA,NM,OK, TX	10,876	14,728	35.4
Region VII IA,KS,MO,NE	5,977	6,688	11.9
Region VIII CO,MT,ND,SD, UT,WY	5,387	7,170	33.1
Region IX AZ,CA,HI,NV	12,358	13,990	13.2
Region X AK,ID,OR,WA	4,725	6,201	31.2

Table 3.3
1985 New Business Incorporations vs. 1986 Bankruptcies

	1985 N.B.I.	1986 Bankruptcies	Column 2/ Column 1
Region I CT,ME,MA,NH, RI,VT	34,082	1,164	3.4%
Region II NJ,NY	94,201	3,673	3.9%
Region III DE,DC,MD,PA, VA,WV	71,281	4,158	5.8%
Region IV AL,FL,GA,KY, MS,NC,SC,TN	121,947	9,904	8.1%
Region V IL,IN,MI,MN, OH,WI	82,608	12,250	14.8%
Region VI AR,LA,NM,OK, TX	63,438	14,728	23.2%
Region VII IA,KS,MO,NE	19,713	6,678	33.9%
Region VIII CO,MT,ND,SD, UT,WY	20,292	7,170	33.3%
Region IX AZ,CA,HI,NV	78,527	13,990	17.8%
Region X AK,ID,OR,WA	18,490	6,201	33.5%

Note: The first year of business is the toughest for most companies. If they are going to fail it usually happens in the first year. This data shows that regional economic conditions have an effect on how new businesses do.

how that type of business fits into the overall economic picture. This practice, if implemented, could also result in making fewer bad loans.

If the SBA takes a good look at the types of loans they make, to whom and for what reasons, they will greatly improve the quality of their loans. If they can learn to better monitor the loans they do make and can get Congress to pass the laws they need to better collect the bad loans, the SBA will become a more efficient organization.

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CHAPTER IV

POSSIBLE SOLUTIONS TO SBA PROBLEMS

The preceding pages highlighted the programs the SBA administers and some of the problems they are encountering with those programs. The options available to the SBA are divided into two categories. The first relates to things the SBA can do within its organization. The second category would include improvements that must be approved by Congress. There is a third section in the Summary, and that has to do with risk management. This report will first examine what the SBA can do to correct the faults in the current programs.

SBA In-House Improvements

The SBA has many avenues open to them for making improvements in their programs. The first area they should concentrate on would be to better utilize their current resources. The SBA received a mission statement from Congress in 1953 when the SBA was authorized. The SBA should reexamine that mission statement, and try to align the current program to fit the stated mission.[1] This should

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[1] P.P.S.S.C.C., p. 2.

lead the SBA to the decision to eliminate farm loans and personal loans. The SBA also has policy statements that need to be adhered to. To receive a loan, an applicant is supposed to be of good character, show managerial skill and be committed to running a good business (page 8). He must have adequate capital and collateral.[2] If the SBA really tried to live up to this policy, they would not have experienced a 19 percent default rate in 1982. In his book on Strategic Management, James M. Higgins pointed out how important policy is to an organization, "...only the organizations that...have viable policies will continue to possess that strategic advantage and will therefore be able to survive and prosper!"[3]

The SBA has many very good educational programs for businesses to take advantage of. First time applicants should be required to attend an SBA sponsored seminar on starting and running a new business before they even apply for a loan. The SBA should also set up a mentor program through SCORE or ACE to give a new businessman a person to go to for help when needed. This mentor could also make helpful visits to the new business its first year to see if things are going as planned. Richard Robinson, in an article in the Academy of Management Journal, found that small

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[2]U.S. SBA, "Business Loans from the SBA," pp. 3-4.

[3]James M. Higgins and Julian W. Vincze, Strategic Management and Organizational Policy, Chapter 1, p. 1.

businesses that used outside advisors as planners, out performed those businesses that did not use planning services.[4] The SBA should establish a policy that encourages the use of outside advisors.

An area the SBA seems to be lagging behind in is information processing and distribution. If loan officers are not receiving lists showing past due accounts until 25 to 40 days after the fact, they cannot be expected to correct the problems in a timely manner. This ineffective information system also affects the SBA's loan collection process. The Inspector General found the average "float" on loan payments was around 15 days. This float costs the SBA about $1.6 million per year.[5] The SBA must improve the flow of timely information to its field personnel. They should also modify their operating procedures for processing payments to reduce the float.

The above recommendations, if implemented, will enable the SBA to tackle the major problem in the SBA's lending program, that problem is loan quality. To improve the quality of its loans, the SBA has to review the entire loan process. The first step would be to improve the training of its lending officers. A lending officer should be trained in all areas of lending, including servicing, monitoring and

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[4]Richard B. Robinson, "The Importance of Outsiders in Small Firm Strategic Planning," Academy of Managemetn Journal, Vol. 25 (1981), pp. 80-93.

[5]P.P.S.S.C.C., p. 58.

collecting. Lending officers have to be made aware of what to look for regarding potential bad loans, not only when they make a loan but also when they are servicing the loan. A good example of what to look for can be found in Charles Bahr's list of "Seven Deadly Signs of Sin." A synopsis appears in Table 4.1, p. 34.[6] Mr. Bahr also feels that "many commercial lenders are usually not terribly reliable at analyzing the numbers of their customers' portfolios. The SBA, if it wants to improve loan quality, will have to ensure that the lending officers are trained at analyzing these portfolios. This training should include determining at what debt level a company can realistically operate. Studies have shown that the level of debt a small business incurs will show an inverse relationship to the success of that business.[7]

The SBA lending officers have to be made aware of alternative lending sources so that they can encourage businesses to try other sources first. As competition for loans heats up, banks have been lowering their rates and loosening their requirements for collateral.[8] This would be a good alternative for an established business with invento-

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[6]C. Charles Bahr, "Sick Companies Don't Have to Die," pp. 686-688.

[7]Hugh M. O'Neil and Jacob Dukes, "Survival and Failure in Small Business," Journal of Small Business Management, January 1986, p. 34.

[8]Ralph King, Jr., "Please Take Our Money," Forbes, July 11, 1988, pp. 41-42.

Table 4.1

A Synopsis of Charles Bahr's

"Seven Deadly Signs of Sin"

1) Reality becomes unglued, management starts to believe its own rhetoric, they spend their energy denying there is a problem.

2) Mangement team breaks down; good people leave.

3) Priorities get out of whack, a mismatch between short-term and long-term considerations develops.

4) Form prevails over content, doing things becasue they worked before, keeping perks when they can least afford them.

5) The numbers don't add up, top executive has marginal number skills, numbers are always late.

6) The lie and hedge stage, officials misrepresent things to their outside constituencies, vendors are paid late, deliveries are late, <u>lenders are put off</u>, "numbers are fudged".

7) The customers' needs cease to dominate, company forgets "the customer is always the customer."

ry or receivables. More and more cities and states are establishing pools of money to help out new and emerging businesses. These non-profit pools not only provide money but management assistance as well.[9]

The SBA has to develop new policies regarding delinquent loans. The SBA has to lobby Congress to pass legislation permitting the SBA to report delinquent loans to credit bureaus. They must also lobby for changes in the law regarding collecting delinquent loans. The P.P.S.S.C.C. recommended that the SBA set target goals (1%) for net charge-offs and use these goals as incentive for their lending officers.[10] This should be enough incentive to encourage the lending officers to reduce the net charge-off of loans. The lending officers also have to be warned not to be overly aggressive in their foreclosing or they might face lender liability lawsuits. The latest tactic used against banks by its customers is to sue. Hundreds of borrowers are taking their lenders to court and winning.[11]

The SBA has to change its policy on who collects delinquent loans. They should have the banks that make the loans, collect the loans if the business defaults on a loan. Currently banks are only collecting 15 to 20% of the loans

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[9] St. Cloud Times, "Non-profit corporation lends money, hope," October 17, 1987, SCCB, p. 18.

[10] P.P.S.S.C.C., p. 23.

[11] G. Bock, "You're Foreclosing? I'm Suing!", Time, May 9, 1988, p. 68.

in default and the SBA tries to collect the rest. It would make more sense for the bank that makes the loan to collect the loan. The banks are more familiar with the business. They have a better idea of what and when to liquidate a delinquent business loan. Banks at the local level are more familiar with how the local court system functions as well.[12] Since the SBA only makes loans to businesses that have been rejected by a bank for a conventional loan, getting the banks more involved in collecting the delinquent loan could be a problem. If Congress will make the necessary changes, the banks will have a bigger monetary stake in collecting delinquent loans. This increased monetary stake and the banks' working relationship with the businesses in question should allow the SBA to turn over most of the collections of delinquent loans to the banks that make the loans. The SBA could save about $9 million over 3 years if this recommendation were implemented.

The SBA should not only get the banks involved in collecting loans, but they should give the banks more responsibility in making the original loan. The SBA's CLP and PLP should be extended to more banks. This would speed up the loan process, reduce the work load on the SBA (reduce the labor force) and make the banks more responsible for the quality of loans made. If all banks had to be certified and if all loans were processed through the PLP or CLP, the SBA

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[12] P.P.S.S.C.C., pp. 9-11.

would be able to monitor which banks were making good loans and which banks needed to be more closely watched. A savings of over $7 million dollars could be achieved in 3 years by increasing participation in PLP and CLP.

The SBA has to increase some of the fees they charge to make programs more cost efficient. Increasing the fee they charge for guaranteeing loans from the current 1% to 2% would bring in an additional $32 million based on FY 1989's budget of $3.2 billion in guaranteed loans.[13] The 1 percent increase would be passed on to the borrower but would not cause him any significant hardship. The SBA should increase user fees in other areas too, but that will take the help of Congress.

The SBA has a great deal of work to do within their organization if they expect to become a more efficient organization. If they can correct the above stated problems, everyone will benefit.

Congressional Changes Needed

One of the biggest challenges facing the SBA will be to get Congress to make the necessary changes that will enable the SBA to become a lean, mean government agency. Congress has constantly added programs to the SBA and expected them to reduce their operating costs. The charges of "pork barrel politics" is certainly evident in many of the SBA's

[13] John Szabo, "SBA Would Alter Program," p. 14.

current programs. Most of this "fat" is a direct result of constant Congressional meddling. Congress now has a chance to rectify their past mistakes and help the SBA become a better, more efficient organization.

The first order of business Congress should tackle would be to lower the percentage of the loan that the SBA will guarantee. Congress set the maximum guaranty at 90% in 1981.[14] That guaranty should be lowered to a maximum of 75% over the next three years. The amount of interest the SBA guarantees should also be reduced to no more than the governments cost of funds. These changes will have a dual effect. Since the banks will have more at risk, they will concentrate harder on making better loans. The SBA can reduce its exposure to risk, which should reduce the SBA's costs over the long run. The P.P.S.S.C.C. estimates that a 34 percent reduction in net charge-offs would be achieved by these changes. These changes would result in an estimated savings of $72 million over three years.

Next, Congress should investigate who gets loans and why these loans are granted. Congress has to get the farmers out of the SBA programs and keep them out. Let the Farmers Home Administration take care of the farmers and let the SBA concentrate on business loans. The SBA staff are not experts in the farming business, the FmHA people are. These farm loans have been a drag on the overall SBA loan

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[14] U.S. SBA Annual Report 1984, p. 32.

portfolio. In 1982, over 22% of the SBA farm loans were past due.[15]

The SBA should also get out of the direct lending business. The SBA's direct loan program is a lending program of last resort. The number of delinquent loans in the direct loan portfolio reflects just how poor these loans are. Direct loans strain the already limited resources of the SBA's staff. Direct loans take more time to administer, monitor and collect. If the direct loan program was eliminated, a savings in loan losses and the resulting reduction in SBA staff costs would save the SBA $22.6 million dollars over the next three years.[16]

Congress needs to make significant changes in the SBA's disaster loan programs. Currently, disaster loans are divided into two categories: business loans or personal loans. The SBA should not be in the business of making personal loans and should eliminate this part of their loan program. Business loans are further divided by the type of loss: Physical loss or Economic Injury loss. Economic Injury Disaster Loans (EIDL) are for businesses whose cash flow has suffered because of a disaster or change in the economy. The availability of these loans discourages a business from saving for "a rainy day." The philosophy of spending more when business is good and get a government

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[15]P.P.S.S.C.C., p. 28.

[16]P.P.S.S.C.C., p. 15.

handout when business is poor must end. Congress should eliminate EIDL's or at least charge an interest rate above the government's cost of funds.

That leaves only Physical Disaster loans available for small businesses. The SBA estimates that 85 percent of all disaster loans are flood related.[17] The majority of the flood losses could have been covered by insurance from the National Flood Insurance Agency. The SBA should stop subsidizing a business's insurance needs. If flood insurance is available, but not purchased, the SBA should not be making a reduced interest loan (half of the government's cost of funds) to a small business.

If Congress will make these changes, the SBA can get back to its basic function of guaranteeing small business loans at a reasonable, guaranteed rate. If Congress can't make the tough political decisions, the SBA will be forced to continue subsidizing people and businesses they shouldn't.

There are a few other changes Congress needs to make. It was mentioned earlier that the SBA is not allowed to report delinquent loans to credit bureaus, that should be changed. The law also forbids the SBA from hiring private collection agencies to collect delinquent loans. Congress should allow or even make mandatory the hiring of collection agencies to get the most from their long list of delinquent

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[17] P.P.S.S.C.C., p. 32.

loans. The SBA collects about 10 cents on the dollar verse 30 cents on the dollar in the banking industry. This could improve to possibly 50 cents on the dollar in some situations. More and more investment pools are investing in bad loans. "A more liquid market is developing in buying distressed bank debt from banks," says Paul Levy. "It will become a real market."[18] The SBA could recover anywhere from $118.5 million to over $350 million if they hired private collection agencies to work the charged-off loans currently on the SBA's books.[19]

Congress should also consider letting the SBA check the IRS's record of businesses that are in default on a SBA loan. If the borrower is getting a tax refund or has other assets hidden from the SBA, the IRS should be able to seize the return and/or assets to satisfy the debt owed to the SBA.

There are a few changes that Congress could make to improve the SBIC program. SBIC's are not charged a fee for the SBA guarantee they receive. The SBIC program costs the SBA about $1.6 million dollars a year to operate. A 1% user's fee would cover the cost. This user's fee would not adversely impact the profits of the SBIC's.[20] Congress should impose a user's fee on the SBIC's to at least cover

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[18]Christopher Farrell, "The Vulture Capitalists Are Circling, Business Week, September 5, 1988, p. 84.

[19]P.P.S.S.C.C., p. 14.

[20]P.P.S.S.C.C., p. 57.

the direct operating cost to the SBA.

Congress should also give more money and more leeway to the inspectors who monitor SBIC's and other SBA programs. Currently the SBA is required to conduct an annual audit of all SBIC's. This is next to impossible given the number of auditors and the number of SBIC's to be examined. If the SBA were required to make only periodic inspections, they could concentrate their auditing forces on the troubled SBIC's instead of doing annual audits on healthy, well-managed SBIC's every year.[21] Increasing the number of auditors would be a worthy, cost effective plan. During the six-month period from April 1, 1987 to September 30, 1987, the average savings/avoidance cost discovered by each auditor averaged $250,176.[22] With those kind of numbers, extra auditors would generate a positive cash flow instead of additional expense.

Risk Management

The SBA and Congress can make all of the above changes and the SBA loan program could still suffer unexpected losses if they don't examine one thing very closely, RISK MANAGEMENT. The SBA has to determine how much risk they want to be exposed to and the amount of money they are

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[21]U.S. SBA Semiannual Report of the Inspector General, p. 47.

[22]EBIT, p. 37.

willing to lose. The appropriate level of risk for any business is extremely hard to determine. For a government agency that deals with all types of businesses, that appropriate level of risk may be next to impossible to figure out. What the SBA may have to implement in the future will be a program that can determine the level of risk each loan made represents. With each loan having a predetermined risk factor, the next step would be to assign a total acceptable risk level for each bank, state or region. The sum of the risk factors for all the individual loans in each bank, state or region could not exceed the predetermined limits. Once that designated unit reached their total combined risk level, they could no longer make any loans until the risk level of the current portfolio was reduced.

In an article in the Federal Reserve Bank of Cleveland's Economic Review, Robert B. Avery discusses a plan to determine the total risk of a bank and how to use that risk level to determine the cost of FDIC insurance premiums.[23] The SBA should adopt a similar idea for determining what to charge a bank for its loan guarantee. Under the current policy for a business to get an SBA guaranteed loan, that business has to be denied credit by a bank first. This policy allows the banks to accept the low risk loans

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[23]Robert B. Avery and Terrence M. Bettan, "A Comparison of Risk-Based Capital and Risk-Based Deposit Insurance," Economic Review, Federal Reserve Bank of Cleveland, 4th quarter, 1987, pp. 20-30.

without an SBA guaranteed. The SBA is asked to guarantee only the more risky loans. The SBA should get compensated by the banks for assuming more than their share of risk. This is being considered by the Federal Reserve Board given the current problems in the S & L and Banking industry.[24]

The SBA has to deal with risk both in the beginning of the loan process and after the loan is granted. C. Baumbach, in his book on Entrepreneurship, says that "The risk of failure...can be reduced considerably if everything is investigated before actually starting a business."[25] This is the attitude the SBA should take when it reviews all loan applications.

What happens or can happen after a loan is granted also has to be an element brought into the formula for determining the risk. A report from the Brookings Institute stated that if this country were to have a recession, 10 percent of the publicly held corporate debt would end up in default.[26] This high level of corporate debt, much of it from the sale of junk bonds, has to be a real concern of the SBA. This sort of information, if it becomes reality, would devastate most banks' loan portfolios. The SBA has to analyze this

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[24]Catherine Young, "Banks Should Pay More for Those Government Guarantees," <u>Business Week</u>, April 14, 1988, p. 30.

[25]Clifford Baumbach, <u>Entrepreneurship and Venture Management</u>, p. 135.

[26]Steven Brooks, "Corporate Debt: Too Much, Too Fast." <u>St. Paul Press Dispatch</u>. November 7, 1988, p. 6.

economic information and use it, to help limit its exposure to future risk.

CONCLUSION

The SBA serves a vital need for the small businesses in this country. The SBA should be kept an independent federal agency and not dismantled with its loan portfolio sold off for 20 cents on the dollar.[27] The SBA should eliminate limited, special interest programs that are not cost effective. The SBA must work with lenders in the private industry to improve the quality of their loans and limit the risk that they both incur. If the SBA can do all of these things, they will be fulfilling their mission "to aid, counsel, assist and protect the interests of small business concerns."

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[27] Jay Finegan, "Cleaning House," p. 34.

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DATE DUE	BORROWER'S NAME