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TAKING ON MORE RISK: EXAMINING THE SBA'S CHANGES TO THE 7(A) LENDING PROGRAM PART I

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTEENTH CONGRESS

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TAKING ON MORE RISK: EXAMINING THE SBA'S CHANGES TO THE 7(A) LENDING PROGRAM PART I

WEDNESDAY, MAY 10, 2023

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

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building, Hon. Roger Williams [chairman of the Committee] presiding.

Present: Representatives Williams, Luetkemeyer, Stauber, Meuser, Salazar, Ellzey, Molinaro, Alford, Crane, Bean, LaLota, Velázquez, Golden, Phillips, McGarvey, Gluesenkamp, Perez, Scholten, Chu, Davids, and Pappas.

Chairman WILLIAMS. Good morning, everyone. I now call the Committee on Small Business to order.

Without objection, the Chair is authorized to declare a recess of the Committee at any time.

The committee is here today to hear testimony from Mr. Patrick Kelley, the U.S. Small Business Administration's associate administrator of the Office of Capital Access. Thank you for being here today, sir.

And now I recognize myself for my opening statement.

I want to welcome everybody here today to today's hearing which will focus on the much-needed oversight of the Small Business Administration and their proposed changes to the 7(a) loan program. The SBA administers several programs to support small business that encourage lenders to provide loans to main street who might not otherwise be able to obtain financing. Their flagship 7(a) loan program offers government guaranteed loans to eligible small businesses for short- and long-term capital needs.

The SBA is in the process of finalizing two rules that will represent the most significant changes to the program in decades. Well, there are many more troubling aspects of these rules. The most problematic in my opinion are the changes to the underwriting standards while simultaneously allowing more fintech companies to become 7(a) lenders. The SBA is throwing away the nine prospective elements of underwriting that lenders have been using for decades to determine if a borrower is eligible for a government-backed loan. Instead, lenders will now be able to use whatever lending criteria they see fit considering that taxpayers will go and be the ones on the hook if a significant portion of those loans go

bad. We should not be loosening the criteria for lenders to give loans.

Additionally, these rules reverse the moratorium on licensing new Small Business Lending Companies, better known as SBLCs. The moratorium was initially put in place in the 1980s because the SBA recognized that they were not capable of being the primary federal regulator of these entities. Given the unacceptable levels of fraud that occurred in the SBA's pandemic programs, I have serious concerns that the agency is not up to the task of taking on more responsibility.

I am not alone in raising these concerns about the SBA's capabilities. Last month, when the SBA's Inspector General testified before this Committee, he noted the significant challenges that the agency will face in managing the increased loan volume going forward as well as the significant shortages of staff within the department charged with overseeing SBLCs.

There are serious concerns that these changes to the program will be detrimental to taxpayers and small businesses alike. If more loans start to default, the fees to the program are going to have to be raised, or the agency will come to Congress to ask for more taxpayer dollars to make up for the shortcomings. The policy noticed released late last night which lays out implementation for just one of the final rules is not sufficient and does not satisfy our concerns.

This is an extremely important hearing as we in Congress discuss what the future of this program will look like, and what we must do legislatively to ensure the programmatic integrity of the 7(a) program in the future. I want to thank you all again for being here with us today and I am looking forward to today's conversation.

And with that, I yield to our distinguished Ranking Member from New York, Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman, for holding this important hearing.

The Small Business Administration's 7(a) program is the agency's flagship lending initiative. Under the 7(a) program, SBA guarantees significant portions of loans encouraging lenders to extend credit to small businesses that might not typically be able to obtain financing. So far in FY23, the SBA has approved over 30,000 loans totaling more than $14.6 billion proving just how integral the 7(a) program is to our nation's entrepreneurial ecosystem.

7(a) loans strengthen local communities, create jobs, and move our economy forward. Given the critical nature of the 7(a) program, this committee must carefully consider and vet any significant changes. Last month, SBA issued two final rulemakings that have substantial implications for the 7(a) program. The affiliation rule loosens lending criteria, updates loan conditions, and eliminates various affiliation standards. While the second rule on SBLCs ends the SBA's longstanding moratorium on licensing new SBLCs. In the final rule, SBA states that it can license and supervise three new SBLCs and it is speculated that some, if not all, of these new licenses will be granted to fintech companies.

SBA instituted these rules to address persistent gaps in access to capital as part of the Biden administration's broader economic agenda.

Increasing access to capital for underserved entrepreneurs has been and will remain a priority for me as the top democrat on this committee. However, I am apprehensive about the SBA's decision to remove many of the longstanding guardrails and program requirements on loan criteria and affiliation standards that have served the 7(a) program well while also lifting its moratorium on the licensing of new SBLCs.

I am especially concerned by the possibility of new SBLC licenses being granted to non-federally regulated fintechs with no experience in 7(a) program lending.

Researchers have highlighted that fintechs facilitated most of the significant fraud associated with the Paycheck Protection Program. I appreciate SBA taking this situation seriously and the steps the agency has taken thus far to hold the blatant actors responsible for their actions.

With that said, we will be doing a disservice to American small business owners by moving forward with changes that weaken and destabilize a highly successful program that has helped millions of entrepreneurs. The last thing we want is for unintended consequences of sweeping changes by rulemaking without detailing accompanying SOPs to harm the future of this program which is an essential tool for many small business owners and entrepreneurs.

On the matter of SOPs, I remain concerned about policy changes being released later at night to everyone's surprise. As many of us on this dais have indicated, it is alarming that major programmatic changes can come on a whim, no matter the administration. These continued changes to the incredibly important details are the reason we are taking our time to truly understand the impact they will have.

As SBA moves forward with these rule changes, this committee must ensure that they are responsibly implemented and do not negatively impact the 7(a) program and individual borrowers. Ensuring that businesses owned by women, people of color, and underserved groups is an important goal that I share with Administrator Guzman.

I look forward to hearing from Mr. Kelley on the steps SBA is taking to ensure these rules do not risk the integrity of the 7(a) program.

I remain committed to filling the gaps in the market in a bipartisan and thoughtful way. The Small Business Committees in the House and the Senate have proven that we can work together to make a difference for our main street businesses.

Whether during a global crisis or hard fought SBIR reauthorization, we have always come together to put politics aside and do right by our nation's job creators. I look forward to doing just that again and working with the SBA and my committee colleagues in both the House and the Senate to find a solution.

Thank you, and I yield back.

Chairman WILLIAMS. Thank you very much.

And I will now introduce our witness.

It is my privilege today to introduce our witness, Mr. Patrick Kelley. Mr. Kelley is the associate administrator for the Office of Capital Access at the Small Business Administration. At the SBA, Mr. Kelley leads the agency's Office of Capital Access and has been leading the charge for the rules change we speak of. Mr. Kelley is a graduate of Colgate University and Boston College Law School. In a previous stint at the SBA, Mr. Kelley served as deputy chief of staff, deputy association administrator, and senior advisor at the agency and also worked at the U.S. Department of Commerce. In between his time at the SBA, Mr. Kelley served as the executive vice president for channel partnerships at Live Oak Bank where he primarily worked for the bank's corporate strategy and development team.

Mr. Kelley, I want to thank you for joining the Committee today and I am looking forward to today's important conversation.

So with that I now recognize Mr. Kelley for his 5-minute opening remarks.

STATEMENT OF THE HONORABLE PATRICK KELLEY, ASSOCIATE ADMINISTRATOR, UNITED STATES SMALL BUSINESS ADMINISTRATION

Mr. KELLEY. Chairman Williams, Ranking Member Velázquez, Members of the committee, it is a pleasure to be here on behalf of President Biden, Vice President Harris, and Administrator Guzman. As Chairman Williams noted, I have been the associate administrator for the Office of Capital Access since March 1, 2021. During that time I have been responsible for the CARES Act programs, as well as the Restaurant Revitalization Program which was a part of the American Rescue Plan, and then also in July of 2021, I took over responsibility for originations for the disaster loan programs. Historically the Office of Capital Access has overseen the post-close servicing of those assets.

With respect to the core programs that have been highlighted by the Ranking Member's statement, as well as the Chairman's statement, I also oversee the 7(a) loan program, the 504 program, the SBA Microloan program, and the Surety Bond program.

Since March 1, 2021, under Biden-Harris and when Administrator Guzman came on board at the latter part of March, we have focused like a laser on the outstanding issues that we inherited with respect to fraud, waste, and abuse associated with the Paycheck Protection Program, as well as the COVID EIDL program. During the 2-year period that I have overseen these programs, we have reviewed close to 42 million, 41.9 million applications across those programs. We have approved across those programs 21 million applications for close to $1.2 trillion. We have identified $6.7 million suspicious loans. We have done that through automatic screenings, as well as data analytics or supervised learning tools that the GAO and the Inspector General have highlighted are best practice with respect to identifying suspicious activity.

There have been close to 3.8 human-led reviews which have resulted in referrals to the Office of the Inspector General, and we estimate that a million loans that were disbursed across the PPP program and the COVID EIDL program represent $41 billion of total fraud undisbursed. The estimated number of fraud prevented

is north of $100 billion. And there was $500 billion that was never allowed to move forward as an application through the automated screening.

In the coming days, Administrator Guzman will be releasing a white paper report detailing all this, as well as the detailed steps, the automated screening, the supervised learning model that we deployed, as well as the human-led reviews and the referrals to the Office of the Inspector General.

President Biden's budget lays out a request for $100 million for the Office of the Inspector General as a result of this. They currently have processed 776 indictments. They have testified before this Committee to be working on 500 open case files, but certainly, the numbers that we have referred, that the SBA has referred to the Office of the Inspector General, the so-called bad guys that we believe they should go after need resources.

With respect to the lessons learned from this and how we will handle the issues and concerns that were highlighted by Chairman Williams and Ranking Member Velázquez's opening remarks, we will be moving forward as we did for phase three of the Paycheck Protection Program and as we did for the Restaurant Revitalization Program with a regulatory compliance and fraud framework pre etran authorization and that process will validate not only know your customer or fraud issues like OFAC and other issues but it will also identify alerts and flags with respect to eligibility.

The core of eligibility is a for-profit company domiciled in the U.S., an operating company considered small by SBA size requirements with no character issues and legal resident status. All of those indicators were vetted in the Restaurant Revitalization Program and it is important to understand that we did not need to make the tradeoff in 2020 between speed and certainty. We were able to stand up a program in 30 days post-passage, disburse $28.6 billion to 101,000 restaurant and related entities, and we were able to do that with certainty that there would not be fraud or ineligible folks.

So I look forward to taking questions and I appreciate the opportunity to address any concerns. Thank you.

Chairman WILLIAMS. Thank you.

We will now move to the Member questions under the 5-minute rule. We need direct answers, not long answers if you would do that for us, please.

Mr. KELLEY. Yes.

Chairman WILLIAMS. I recognize myself for 5 minutes.

Last week, the White House put out their Small Business scorecard that states the SBA saw a record volume of lending in Fiscal Year 2022. This includes $43 billion in capital approved for small businesses across SBA products and an increase in small loans under $150,000 in the SBA 7(a) loan program.

Now, this is the opposite of everything that the SBA has been saying to justify these rule changes and different than what you told our staffs regarding the need to bring more lenders into the program.

So my first question, Mr. Kelley, so who is not being truthful, the SBA or the White House?

Mr. KELLEY. Neither is not being truthful. What we have stated is that over a 5-year period there is a 40 percent, or 50 percent decline in the number of loans and dollars lent under $150,000. So what we are reporting in those numbers is a year over year increase. So since the Biden-Harris administration took over, and as Ranking Member Velázquez referenced prioritize making small dollar loans an issue, we have seen improvements in year over year. There is still a stark decline in the access of capital for the loans under $150,000.

Chairman WILLIAMS. So the SBA's Office of Inspector General has found that many nondepository lenders in the 7(a) program were subject to limited oversight until a default occurs and identified significant issues within the agency relating to lender oversight. The Inspector General also noted a failure of the SBA to conduct regularly scheduled examinations over high-risk lenders. In short, the OIG has reported on many issues that questions the agency's ability to be a regulator. And I share these serious same concerns.

Last night, the SBA released the policy notice for just one of the final rules to lenders that will help implement these new rules. It appears that for loans under $500,000, the agency removed almost all underwriting criteria and lenders are allowed to give out loans however they see fit to anybody. In carving out smaller loans from any standard underwriting requirement is one of the worst ways to mitigate risk and will increase the changes of predatory lending on small businesses and taxpayers. So the agency is bringing on more lenders and diminishing underwriting standards at a time when the agency is already failing to conduct all the necessary oversight over the risk lenders. You do not need to be bigger; you need to be smaller. And this is a recipe for disaster.

So Mr. Kelley, what percentage of the current loan portfolio is under $500,000? And how will the SBA monitor the many different underwriting models that will be used by the lenders since you took away the uniform standard?

Mr. KELLEY. So, two things. First, the reports you reference from the Office of the Inspector General reference high-risk lenders based on a quarterly rank order that the agency and the Office of Credit Risk Management does to all of its assets. We rank each outstanding loan as high risk, medium risk, and low risk, and then based on the percentage of a lender's portfolio, we schedule supervised oversight as a result. That report does not single out a type of lender. It speaks to all lenders. And the overwhelming majority of lenders that the IG has reviewed in its sample set are, in fact, regulated entities, banks and credit unions. So that is number one.

Number two, with respect to the underwriting standards, since 2004, and under a Republican Congress and under President Bush, the program SBA Express, has existed. And for 20 out of 23 years, when you compare a term loan originated by those lenders under that program versus a term loan with a standard 7(a) referencing the nine criteria that previously enumerated in the reg, the term loans with the standard consistent with your similarly sized non-SBA policy has outperformed in terms of default rate and loss rate.

So what I would say to Chairman Williams, and I think we can all agree, is that letting the marketplace lenders and removing red

tape has demonstrated in that program which was originally a pilot program that a Republican administration started. In addition, a Republican administration expanded that exact same criteria to Patriot Express for veteran-owned loans and Community Express to attack the very same problem that was identified under Bush which is the dearth of small dollar loans going to sole proprietors. The rough order of magnitude of loans under 50,000 in terms of units is somewhere between 40 to 45 percent annually, and 60 percent of those units have been originated in the SBA Express program because that standard allows the lenders to follow their credit and collateral policies and it has performed better.

Chairman WILLIAMS. Okay. In a letter my Senate colleagues sent you, you stated that the SBA has the same standards as all the other federal regulators including the Bank Secrecy Act and the other Know your Customer anti-money laundering requirements. Now, I have been told this simply is not true. So I would like you to set very quickly the record straight. Can you confirm that the SBA does, in fact, require all SBLCs to comply with the FPSA and KYC regulations, and where can I go to see the guidance that you gave to lenders on how to comply with these requirements?

Mr. KELLEY. You can go to the SOP and the letter clearly states that all lenders participating, and it should be noted, and you noted it in your opening remarks, Chairman, that while there has been a moratorium for 40 years, those SBLC licenses could always be purchased by any type of lender. And in fact, 61 times were purchased and approved. And there has not been an issue with the Committee in that 40 years regarding those 61 transfers.

With respect to the oversight——

Chairman WILLIAMS. Our time is——

Mr. KELLEY.—of those entities, it is exactly the same across all entity type.

Chairman WILLIAMS. Thank you.

I now recognize the Ranking Member for 5 minutes of questions.

Ms. VELÁZQUEZ. Thank you, Mr. Kelley, for being here today.

The rules are set to go into effect within the next week; correct?

Mr. KELLEY. That is correct.

Ms. VELÁZQUEZ. Yet, the SBA did not release any information about the implementation of either of these two rules until late last night and SOPs still have not been published. Can you explain why the SBA has waited so long to release any guidance when it knew the rules were going into effect this week?

Mr. KELLEY. Yes. So as has been noted by Ranking Member Velázquez and Chairman Williams, I have participated in the Obama administration. I also, as Chairman Williams noted, participated for a large SBA lender for 6 years in the private sector. There is nothing about the implementation with respect to the posting of procedural notices that precede SOP publication post rules becoming final. As you know, we are in the 30-day window before the rules become final. We wanted to get the procedural notice out before the rule becomes final. We achieved that and the SOPs will follow. The language that is reflected in those procedural notices will be reflected in the SOP.

Ms. VELÁZQUEZ. Okay. When do you expect the SOP to be published?

Mr. KELLEY. I think it will be published, if not today, this week.

Ms. VELÁZQUEZ. When you went to the Senate you stated that it will be released on May 3.

Mr. KELLEY. Yes.

Ms. VELÁZQUEZ. Why did you not release it on May 3?

Mr. KELLEY. Chairman Velázquez, could I——

Ms. VELÁZQUEZ. Ranking Member. Soon to be Chairwoman.

Mr. KELLEY. Sorry, sorry, I apologize. Sorry. Sorry, Chairman Williams. Sorry. Apologies. Apologies. I gave you a promotion there.

So, I, too, would like a promotion. I would like to be able to deliver timelines——

Ms. VELÁZQUEZ. Okay. My question then is, you know, you say May 3. It did not happen. How is the SBA expecting lenders to comply with the rule without the SOP?

Mr. KELLEY. So as a person that worked for the nation's number one SBA lender by dollars lent in the private sector, when rules were changed, so, for example, in 2018, 2017, rules were promulgated by the Trump administration. The order of operations that we are following is exactly consistent and prior——

Ms. VELÁZQUEZ. That does not make it right.

Mr. KELLEY. Well, it makes it necessary in terms of there is an order of the way that APA and our procedures call for in terms of you pass the rule, the rule becomes final, you cannot operate until the rule has become final. If you want to give the guidance before the rule becomes final, which we have done, and then you do not want to proceed or create confusion that lenders can operate before the rules become final.

Ms. VELÁZQUEZ. Have you considered delaying the rules in order to give lenders and borrowers more time?

Mr. KELLEY. No, because the changes in the rules, specifically the underwriting criteria, all remove red tape and bureaucracy that banks and credit unions in my 13 years of being exposed to this have asked for repeatedly and routinely over every year.

Ms. VELÁZQUEZ. Okay. The final rule changed the definition of an SBLC from what was proposed in the rule. The proposed rule stated that an SBLC was "only to make loans pursuant to the 7(a) and Microloan program." But in the final rule, SBA deleted the word "only." By removing the word "only," was the intent to allow SBLCs to begin making non-SBA loans?

Mr. KELLEY. Well, today, all of our lenders make non-SBA loans. We are responsible for overseeing the loans that they make within our program. And as the IG has highlighted in its Management Challenges Report, the key areas that we are responsible for oversight are eligibility and reasonable reassurance of repayment. And so, we are responsible for overseeing that.

I cannot speak to the exact clause that you are talking about but the intent has always been an SBLC——

Ms. VELÁZQUEZ. Right here. Right here. Small business lending companies. It is a nondepository lending institution that is SBA licensed and is authorized by SBA to—and what was proposed in

the proposed rule, in the draft, only to make loans pursuant to section. The word "only" was deleted.

My question to you is, if SBLCs were to begin issuing both SBA-backed loans and non-SBA loans, are you concerned that these lenders will prioritize their private issuances over their SBA portfolio defeating our goal to increase access to capital for the smaller loans?

Mr. KELLEY. Yes. So, and feel free to engage with lenders on this point. But one of the things that happens today is non-bank lenders or competitors make loans that are subordinate to senior debt or SBA loans today. So it is the case today that small business owners seeking working capital seek out additional capital if they can get it.

With respect to the issue that you are speaking to, we dealt with this issue, for example, in the Community Advantage Program where a community advantage lender, a CDFI, was originating loans on an interim basis and then refi-ing them into the Community Advantage loan program.

Ms. VELAZQUEZ. What I do not understand is why did you make the deletion? Why did you delete "only"?

Mr. KELLEY. Yes. I am happy to follow up with your staff.

Ms. VELAZQUEZ. Okay.

Mr. KELLEY. Because while I a lawyer——

Ms. VELAZQUEZ. My time has expired.

Mr. KELLEY.—I have to take a look at the actual citations that you are citing. Yeah.

Chairman WILLIAMS. All right. Thank you.

I now recognize the Members for 5 minutes.

And I first recognize Mr. Luetkemeyer from Missouri for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Welcome, Mr. Kelley.

When you opened your remarks you said you are here representing the president and vice president of the United States. Have you spoken to them recently?

Mr. KELLEY. No. I am a political appointee and so I work at the pleasure of the——

Mr. LUETKEMEYER. But you are representing them you said.

Mr. KELLEY. Of course.

Mr. LUETKEMEYER. Okay. Do you talk to the White House administration at all about——

Mr. KELLEY. Yes. Yes.

Mr. LUETKEMEYER.—the programs?

Do you know if Ms. Guzman ever talks to the White House?

Mr. KELLEY. Yes.

Mr. LUETKEMEYER. Does she talk to the president?

Mr. KELLEY. Yes. She was with the president Monday, last Monday.

Mr. LUETKEMEYER. Well, that is a first because I can tell you we have asked that question multiple times of her in this Committee and we never got an answer from her. That may be the first time she has ever met with him as far as we know.

Mr. KELLEY. It was a publicly attended event in the Rose Garden——

Mr. LUETKEMEYER. Was it about small business issues?
Mr. KELLEY. It was for National Small Business Week. Yes.
Mr. LUETKEMEYER. Okay.
Mr. KELLEY. And it was celebrating the nation's small businesses.
Mr. LUETKEMEYER. Well, I hope she talked about some of these programs and how they are——
Mr. KELLEY. She did.
Mr. LUETKEMEYER.—negative affecting the small business community because that to me is what needs to be done.
Okay, Mr. Kelley, how many people are at the SBA?
Mr. KELLEY. I think——
Mr. LUETKEMEYER. In the office here in D.C.?
Mr. KELLEY. In the office here in D.C.? I am not sure what the total head count for the agency is I think something around 2,000-plus. And then it goes up and down.
Mr. LUETKEMEYER. How many people are in your department? Let's put it that way.
Mr. KELLEY. So there are 300 FTE in the historically defined Office of Capital Access. We——
Mr. LUETKEMEYER. Okay. How many people showed up for work today?
Mr. KELLEY. All of them.
Mr. LUETKEMEYER. In this building, in your SBA building, how many of them showed up today?
Mr. KELLEY. I do not have a head count of who showed up physically today. As you know——
Mr. LUETKEMEYER. Are they all required to show up to work every day?
Mr. KELLEY. Yes.
Mr. LUETKEMEYER. I am not talking about off campus being qualified work. I am talking about physically being in your office.
Mr. KELLEY. They are complying with what they have been asked to do.
Mr. LUETKEMEYER. That is not what I asked. I am sorry; that is not what I asked.
Mr. KELLEY. I understand that but that is how I am answering your question.
Mr. LUETKEMEYER. I asked a question of whether they are actually showing up in the office that you work in——
Mr. KELLEY. Yes. I understand——
Mr. LUETKEMEYER.—every day.
Mr. KELLEY. I understand your question. And civil servants are complying with what they are asked to do. They serve——
Mr. LUETKEMEYER. No, you are not answering my question.
Mr. KELLEY.—on behalf of the public and they are responsible to comply with what they are asked——
Mr. LUETKEMEYER. Okay. So they are not showing up at your office is what you are saying because——
Mr. KELLEY. They are doing their job as they were required by their position descriptions and as their supervisors——
Mr. LUETKEMEYER. Okay. So you are telling me that they are not which that goes to the point——

Mr. KELLEY. Well, it is no different than any of the private sector entities that are doing exactly the same thing.

Mr. LUETKEMEYER. I am not talking about the private sector, Mr. Kelley. I am talking about your office that you are in charge of. The people are not showing up personally to sit at a desk in your office building to do their work. You are allowing them to do it from home which that is fine if you want to do that but the next question is whenever you have, well, in 2019, the inspector general claimed that the Office of Credit Risk Management failed to perform effective oversight over the OCRM, only conducted 108 of its planned 358 reviews of high-risk lenders. COVID-19 only exasperated this issue as oversight staffing levels decreased by an additional 38 percent. Despite this, the SBA has lifted the SBLC moratorium allowing for more nondepository entities who are purely regulated by the SBA rather than federal regulators to enter the market. So it goes to the point that the inspector general said you need more oversight and you have less people to do it and they are not even at the office to do it themselves. This is a problem. It is a big problem.

So, you know, I guess the rational is how do you expect to get anything done whenever you do not have anybody in your office?

Mr. KELLEY. Well, judging by the fact that the agency supported $1.2 of lending and grant activity over a 2-year period where the entire agency was teleworking, I think we have demonstrated that we will do our jobs.

Mr. LUETKEMEYER. Well, thanks to the banks and credit unions that were able to put that all out, which goes back to the point I was wanting to make here a little bit ago. You talked about I think $1.2 billion that went out the door which was great. And you talked about one million applications I think it was, $41 billion in fraud.

Mr. KELLEY. Yep.

Mr. LUETKEMEYER. What percentage of that is EIDL versus PPP?

Mr. KELLEY. It is roughly 45-55 PPP to COVID EIDL. So, for $46 billion we paid the lenders to——

Mr. LUETKEMEYER. Okay. So the EIDL program——

Mr. KELLEY.—instances of fraud.

Mr. LUETKEMEYER. The EIDL program was roughly $400 billion and they had about $20 billion worth of fraud. And then the PPP program was about $800 billion and they had about less than $20 billion in fraud.

Mr. KELLEY. Or we paid the lenders $46 billion in servicing fees for a 4 percent fraud rate.

Mr. LUETKEMEYER. So it goes to the point though that the PPP program was highly successful and most of the fraud, according to the IG report, was in the fintech fraud.

Mr. KELLEY. That is not what the IG report——

Mr. LUETKEMEYER. Mr. Ware was sitting in that seat about a month ago.

Mr. KELLEY. He did not say that. He did not say that.

Mr. LUETKEMEYER. And that is what he said. So it is hard for you to dispute that, sir.

Mr. KELLEY. It is easy to dispute——

Mr. LUETKEMEYER. So the problem is that you are trying to make up your own set of facts——

Mr. KELLEY. I am not.

Mr. LUETKEMEYER.—which are not verified by the Inspector General Report.

So, again, whenever you go back to the compliance of KYC, BSA, how do you get the fintech companies to be able to comply with that? Because this is where the problem is. This is where, and now you are expanding to the fintech companies. It really begs the question of do you know what the hell you are doing? Because it is putting the fox in charge of the hen house again. You are allowing the very people who are the problem children to be involved in the program and continue to do things without any oversight. This is crazy.

Mr. KELLEY. It is not. And as I mentioned in my opening statement, and as we demonstrated in the Restaurant Revitalization Program as well as Phase 3 of PPP, we have and will place in front of etran authorization our fraud——

Mr. LUETKEMEYER. Were those sort of oversight principles in place during the PPP program?

Mr. KELLEY. Yes.

Mr. LUETKEMEYER. And they were not adhered to and this is why the fraud——

Mr. KELLEY. They were not in place during 2020 under the Trump administration. They were in place under the Biden-Harris administration.

Chairman WILLIAMS. Time is expired.

Mr. LUETKEMEYER. So we put fraud controls——

Chairman WILLIAMS. Your time has expired.

I now recognize Mr. McGarvey from Kentucky for 5 minutes.

Mr. MCGARVEY. Thank you, Mr. Chairman.

Mr. Kelley, thank you for being here today and for providing insight of the SBA's intentions with these proposed rules. I know a lot of small businesses would not be where they are today without the SBA's support including from the 7(a) program. It is critical that we have 7(a) remain an effective program so that small businesses have this, particularly minority-owned businesses, businesses that would struggle without access to capital.

Under the affiliation rule, the SBA is eliminating standardized underwriting requirements for loan issuance and replacing them with a system that considers lending criteria like a borrower's credit score and history and their business's earnings and cashflow. Under the policy noticed that were released late last night and kind of surprised everybody here on the Committee, the SBA is now clarifying that loans over $500,000 still have some semblance of underwriting requirements.

It still seems that the SBA is requiring the bare minimum of prudent lending standards even though the procedural notice from last night indicates underwriting standards applied to larger loans. Can you explain to us why some mandatory underwriting requirements were left untouched and if this could have the potential to affect the SBA's ability to protect small businesses from inappropriate loans and the 7(a) program from significant loan losses?

Mr. KELLEY. Yes. So as I mentioned in my opening statement, the criteria for underwriting and collateral for loans under $500,000 has been used historically since 2004 and before that in a pilot program. So we can look at the default and loss rate history for, and incidentally, 5 out of 10, in some cases 6 out of 10 loans, each fiscal year from 2004 to 2023, were originated with that criteria. So we have performed subsidy calculations and managed to zero subsidy in nearly all of those years with the exception of the Great Recession and a few exceptions during the Trump administration to zero subsidy. So we do not have to guess whether or not that criteria works or what its impact will be because we can look at the last 23 years of its performance.

Mr. MCGARVEY. I appreciate that but at the same time as it is removing standard underwriting requirements, the SBA is lifting the SBLC moratorium. And I think potentially that is opening the program to non-federally regulated lenders through the SBLC rule. So, do you think the combination of these two rules could create a loan evaluation environment where federally regulated lenders that have stricter requirements will be forced to compete with non-federally regulated lenders not subject to the same underwriting requirements?

Mr. KELLEY. No, because the 2004 SBA Express pilot program was created with advisory under the Bush administration with banks, for banks. And it is the banks that have historically used that. So the top 25 depository institutions have credit score loans in the SBA Express program, the Community Express program, the Patriot Express program for years. Credit scoring is used by every bank on the consumer side and it is used to a varying degree, depending on loan size, in the commercial sector. This is not a new development. You heard Deputy Inspector Sheldon Shoemaker in the Senate hearing speak to that fact towards the end of the hearing. It is in the transcript where he reflects on the fact that financial technology, including credit scoring, is used by banks and credit unions today. It is the banks and credit unions who have made up the majority of our lending year in, year out, will continue to do so, and they are the ones that have sought out the changes that we have put in the SOP. Now, as depository institutions, do they want additional competition from nonbank lenders? No, they do not. But in terms of the actual eligibility and underwriting criteria, these are changes they have asked. The National Association of Development Corporations, which represents the 504 CDCs of which there are over 200 in the country, have been working on eligibility issues since 2011 in the Obama administration where they called for the elimination of the personal resource test, as well as the affiliation rule change that we have made final.

So these are things that have long been understood as necessary to remove red tape and bureaucracy to get small dollars out of the loan. It impacts not just the size of the loan but it impacts every gap in the marketplace. So, for example, in rural America there is a dearth of construction financing. There is a dearth of loans to businesses with no collateral. All of these issues are why this program exists, and why lenders are looking to make the core product more cost-effective.

Mr. MCGARVEY. I appreciate that. And obviously, you know, for our small businesses we want to have less red tape and bureaucracy that we can have access to capital in our small businesses. But this is still a piecemeal approach of regulatory and procedural changes often that do not have enough guardrails in them. They often come at the last minute. Do you think that the SBA is risking confusing lenders and borrowers about the actual rules by which they are expected to comply?

Mr. KELLEY. No, because the rules that are reflected in those procedural notices exist today and what is piecemeal is their application. What has made the agency, so what has made lending for SBA hard is you have to hire a nerd like me to figure out all of the different variations within the SOP. What this administrator has done is said you do not have to hire a nerd like Patrick Kelley.

Chairman WILLIAMS. Time is up.

Mr. KELLEY. You can harmonize the rules to optimize the outcome.

Chairman WILLIAMS. I now recognize Mr. Meuser from the great state of Pennsylvania for 5 minutes.

Mr. MEUSER. Thank you, Mr. Chairman.

Mr. Kelley, earlier when Mr. Luetkemeyer was asking you about the number of employees in the office you dodged, you hid the answer. That is a big difference in the private sector. If you ask that question to a private sector company and I ask them often they will say, yeah, 50 percent of our customer works remotely, 50 percent tech service works remotely. You would not answer the question. You were embarrassed by it. And you——

Mr. KELLEY. I said, I said, no, sir. I said——

Mr. MEUSER. There is no question. I take back my time.

Mr. KELLEY.—100 percent, I said 100 percent, no, sir——

Mr. MEUSER. Repeatedly today, you know, something, you might do what you want in your bureau. We have oversight here and you are going to follow the rules of this Committee.

The SBA has the 7(a) rules, have caused great concern among both Republicans and Democrats. Mostly everyone I speak to feels that you are hell bent on rushing these rules without any concern for Democrats and Republicans, ignoring the final rule. Why is that?

Mr. KELLEY. It is not the case.

Mr. MEUSER. We believe it is based upon the facts of the situation and the fact that you are just blowing off any recommendation or question. But you just state that is not the case and that is that?

Mr. KELLEY. Would you like me to elaborate?

Mr. MEUSER. Well, by moving the program, the 7(a) portfolio towards a more subjective underwriting method for loans under $500,000, how does that protect taxpayers from losses, the OIG has concerns, and you have actually used language, maybe not you, to do what they do for loans under $500,000, which is 75 percent of all the 7(a) loans, how does that instill confidence in us?

Mr. KELLEY. The standard that you are speaking to consistent with similar size non-SBA loans and the euphemism that was explained at a bank trade association conference, do what you do, has been around for over 2 decades and is reflected in every budget that has been passed since then with respect to the subsidy cal-

culation. So, lenders came, banks, credit unions, came to the SBA and said back in the 2000s under the Bush administration there is too much red tape associated with small dollar loans, loans at that time under $350,000, and then this body raised the threshold for Express from $350,000 to $500,000. That standard has been in existence. The lenders know this. I understand that they are upset about three additional non-depository institutions potentially becoming SBA SBLCs and they have equated that with fintech and that is why we are discussing the concerns, which are legitimate. Safety and soundness is terribly important.

I have been a part of the agency's creation of the Office of Credit Risk Management since 2010. I was involved with the regs that were put forward to create the Paris framework——

Mr. MEUSER. Thank you.

Mr. KELLEY.—the smart framework.

Mr. MEUSER. ON April 20th, we sent you a letter. Chairman Williams, Vice Chair Luetkemeyer, Chairwoman Van Duyne, myself, about the ability of SBA to be able to handle this, these new responsibilities related to the concerns of IG Ware. It was April 20th, 3 weeks ago, basically. You have never responded. Any reason you did not respond or can we expect a response sometime in the future?

Mr. KELLEY. Yes, you can expect a response.

Mr. MEUSER. Okay. Any time? Can you tell me when?

Mr. KELLEY. In short order. The process goes through an agency clearance process.

Mr. MEUSER. Okay. April 12th, press release, the SBA stated that these new rules will utilize modern technology to make lender oversight and borrower protection stronger. Can you tell us what the technology is to make borrower protection stronger?

Mr. KELLEY. Yes. So, the way that Bank Secrecy Act laws are complied with today is the use of third party databases where you take a unique identifier from each applicant. So in our case we are dealing with TIN, tax ID number for business, applicant, and then owners of 20 percent or more, or in banking vernacular, beneficial owners. We run that against databases to create alerts and flags across 19 different screening categories which traverse eligibility. I mentioned the eligibility criteria earlier. And also, run them against lists like OFAC and other fraud issues. So for the first time in the agency's history, and what is highlighted in the IG's report is that delegated lenders have historically not had anything pre-approved prior to obtaining etran authorization. So, under this administrator we are instituting this not just in our CARES Act programs but in the general business loan programs, including 7(a) and 504.

Mr. MEUSER. When I was revenue secretary in Pennsylvania we implemented something similar. Do you know how much it costs? And is it ready and when will it be ready to be implemented?

Mr. KELLEY. Yes. The great aspect of this from a cost perspective, and this is something we should all celebrate, is that the oversight fees beginning in 2017 can be charged to all the lenders and are on a pro rata basis. And we are able to use other contract vehicles based on a performance base to institute the technology.

Mr. MEUSER. Thank you.

Chairman WILLIAMS. Time is up.

Mr. MEUSER. Thank you.

Chairman WILLIAMS. Thank you.

Next, I recognize Ms. Chu from the great state of California for 5 minutes.

Ms. CHU. Associate Administrator Kelley, I want to thank you and Administrator Guzman for partnering with me to provide a disaster declaration for my community of Monterey Park, California, in the aftermath of the tragic mass shooting in January that took the lives of 11 people. The eligibility for these disaster loans will truly help our small businesses surrounding that shooting site tremendously. So, thank you for that.

I also want to thank you and the administrator for your focus on increasing lending in underserved communities and your 4-year partnership in making the new Community Advantage SBLC program as effective as possible for lenders and small businesses.

I was pleased to see in SBA's recent notice on May 1st that the Community Advantage SBLC will, indeed, be required to make 60 percent of the loans in underserved markets, as in the current Community Advantage program. I also want to thank you for clarifying in the notice what loan loss reserve requirements these lenders will face and for modeling these requirements after legislation that I introduced last Congress. These loan loss reserve requirements will ensure that these small, nonprofit lenders who have been making Community Advantage loans for more than 5 years will have greater flexibility and more capital to do even more lending.

However, the May 1st notice does not address the capital requirements and oversight fees that the new Community Advantage SBLCs can expect. The current Community Advantage pilot program lenders do not have capital requirements which is important because these are small, nonprofit lenders with far less cash on hand than larger financial institutions like banks. Regular SBLCs currently have a capital requirement of $5 million which would be extremely prohibitive if applied to these mission lenders.

Additionally, the regular SBLCs face much higher oversight fees than current CA pilot program lenders, and would again be cost prohibitive if applied to the new Community Advantage SBLCs. The lack of clarity on these questions is especially concerning because the final rule goes into effect on Friday.

We have heard that a standard operating procedure is forthcoming and will cover these details, but can you confirm that the upcoming SOP will clarify that the oversight fees and capitalization requirements within the Community Advantage SBLC program are to remain unchanged from what Community Advantage pilot program lenders currently face?

Mr. KELLEY. Yes. And with respect to capital requirements, as you mentioned, there is a capital requirement threshold for for-profit SBLCs. The capital requirement for the Community Advantage pilot program had historically been applied not on a balance sheet but on a per loan basis because of the issues that you highlight for the nonprofit lenders. It has historically been 10 percent based on your bill and Chairman Cardin's bill. And working with the community, the threshold has been established at 5 percent

with a sliding scale for trialing portfolio performance that is good over 36 months to come down. So, there is no ambiguity. The capital requirement has always been applied through the loan loss reserve on the individual loan in the Community Advantage program. That is what the procedural notice lays out.

For the entire pilot program, Community Advantage lenders, like all lenders—SBLC, credit unions, banks, CDCs, all lenders—are subject to oversight and oversight is charged on a pro rata basis. So the reason that the Community Advantage lenders do not pay as much oversight as for example, Live Oak Bank would have paid, is because in 12 years, together, all 100 plus entities have originated 7,000 loans over a billion dollars. Whereas, for example, Live Oak does close to $2 billion in 1 fiscal year.

So what will continue is on a pro rata basis we will apply oversight to all lenders.

Ms. CHU. Well, the most important question is will that be in the SOP?

Mr. KELLEY. Yes. It is in the SOP today. That is how Community Advantage lender oversight has been applied. I know there has been confusion created in the marketplace by a single voice but I can assure you they have always been charged a pro rata basis and will continue. And that is true for all lenders.

Ms. CHU. And then the high fees. There was a question of the other SBLC lenders having high fees and then the Community Advantage program lenders cannot hardly afford them.

Mr. KELLEY. So I am not sure what that references but let me see if I can just clarify.

So, fees charged to borrowers are universally applied across all lenders and interest rates are capped and universal to all Members. So that was true. What historically was true in Community Advantage pilot——

Chairman WILLIAMS. Time is up.

Mr. KELLEY. Sorry.

Chairman WILLIAMS. Time is up.

Mr. KELLEY. Okay.

Chairman WILLIAMS. Next, I now recognize Mr. Stauber from Minnesota for 5 minutes.

Mr. STAUBER. Thank you, Mr. Chair.

As a former small business owner, I understand how important it is for small businesses to have access to affordable credit without loan programs that enable our small businesses. They will not be able to grow, support jobs, and help countless Americans achieve that American dream.

The Small Business Administration's, including the 7(a) loan program had been a huge success in my opinion and an important tool to small businesses across our great nation.

Like many of my colleagues here today, however, I am troubled by the rules that were finalized last month by the Biden administration addressing the 7(a) program. While I support allowing flexibility for our small businesses and lending institutions, we must ensure the necessary guardrails are place to protect this program.

I have heard from 7(a) lenders and businesses in my district, including community banks and local credit unions that are worried that these rules will jeopardize the future of the 7(a) program.

Mr. Kelley, annually, about how many investigations or reviews did the SBA conduct into high-risk lenders?

Mr. KELLEY. I think it is in the order of magnitude, depending on the fiscal year of $300,000, $400,000.

Mr. STAUBER. Okay. The SBA's inspector general reported that the SBA failed to conduct 108 of the 358 planned review of high risk lenders in the Fiscal Year 2020. That is a third of the high-risk lenders that the SBA missed.

Under the new rules, the SBA will be lifting the moratorium on new licenses and grants for small business lending companies.

With the lifting of this moratorium, what do you estimate will be the increase in new loan activity?

Mr. KELLEY. So I do want to clarify something that has been mentioned regarding the IG report. What the IG report speaks to is that is levels of supervisory review on site, offsite. And so what it references is that those reviews were conducted. They were just conducted at a different level of review in terms of procedure. So I just want to clarify that.

The second thing that I want to speak to with respect to the estimate, so the estimate was included in the proposed rule and the final rule. And so at cruise altitude, typically SBLCs contribute about 450 loans per fiscal year. For example, we have three SBLCs today that are in the top 10 of SBA lending. And as I have mentioned, these licenses have changed hands over the last 40 years 61 times. And the agency has been responsible for approving who becomes an SBLC. So, we review their safety and soundness, their portfolio of performance. And if we do not want to grant a license, we have the discretion not to do so.

Mr. STAUBER. Do you think the SBA has the capacity right now to do the oversight?

Mr. KELLEY. Yes.

Mr. STAUBER. Okay. Do you think lenders and financial institutions need to have proper regulator oversight in order to protect consumers, yes or no?

Mr. KELLEY. Yes.

Mr. STAUBER. Do you believe the Small Business Administration has the capacity, expertise, or bandwidth to be the sole regulator of any financial institution?

Mr. KELLEY. Yes. And what I would like to clarify on that point because it is important, the use case for what we oversee is loan assets. And it is a simpler use case to stand in than it is for OCC or FDIC because, for example, with FDIC or OCC, they have first order problems that they need to address. Let's say the loan portfolio, commercial estate is underperforming. They have second order of concerns, which is the depositors. So if a bank goes under, are we going to honor deposits?

Then they have third order, which is the impact of that in the local marketplace. We have shown throughout the SBA's history that if a lender comes and goes and dissolves, we can transfer the book of assets to another SBA lender and it does not create the disruption or the need for intervention on the part of the federal government. So those loan portfolios can be transferred. They are conforming assets, which means they are easy to underwrite from a diligence perspective. We have a rank order of the quality of the

credit profile on a quarterly basis. And as a result, a willing buyer will take that asset portfolio.

So if we decide that someone is not participating in lending as we do on a quarterly basis through the Loan Oversight Committee, we can remove their delegated authority.

Mr. STAUBER. Okay.

Mr. KELLEY. The director of OCRM can suspend them at her complete discretion for up to 2 years pending an investigation. And we can ultimately debar the lender from participation.

Mr. STAUBER. Thank you for that explanation.

At the end of the day I have two main concerns. First, the SBA's track record in protecting against fraud, most recently during our PPP leads me to conclude that the SBA does not have the capacity to carry out its oversight rule over an expanded 7(a) program, let alone act as a chief regulator of any financial institution.

Second, I am deeply concerned that local community banks and credit unions in Northern Minnesota will have more oversight, scrutiny, and regulation put on them than the Silicon Valley fintech startups. We must protect the 7(a) program. And I yield back.

Mr. PHILLIPS. Mr. Chairman, before Mr. Stauber leaves I think we should wish him a Happy Birthday.

Chairman WILLIAMS. Well, I do not know if he wants us to or not.

Mr. LUETKEMEYER. Mr. Chairman, I second that.

Mr. PHILLIPS. I withdraw my motion.

Mr. STAUBER. I am celebrating my 39th birthday 19 times, Dean.

Chairman WILLIAMS. Okay. I now recognize Ms. Davids from Kansas for 5 minutes.

Ms. DAVIDS. Thank you, Chairman. And thank you, Mr. Kelley for joining us. I think that this has probably been one of the more lively Small Business Committee hearings I have been in. But it, I think, reflects how imperative oversight is as it relates to protecting our small businesses and then, of course, as Mr. Stauber said, the integrity of the 7(a) program.

I want to jump right into a follow up actually to some of the questions that Mr. Stauber was asking which is around the regulation of the lenders. Can you like share a bit about where you believe the SBA's statutory authority comes from to examine what would normally be the core requirements of a lending institution or depository institution that has the variety of assets that you were describing earlier, whether it is capital requirements, liquidity, risk management. Can you share where you believe the statutory authority comes from for SBA to be able to do that?

Mr. KELLEY. Yes. Under the Trump administration there was a law passed with the Republican Congress outlining and detailing the role and responsibility of the Office of Credit Risk Management located in the Office of Capital Access to do all of those things which has historically been understood to be authorized under our administration of the program from the Small Business Act, section 7(a), which requires that we determine reasonable reassurance of repayment and eligibility for the program. So in order to determine reasonable reassurance of repayment——

Ms. DAVIDS. I am sorry; your reasonable reassurance of repayment is not the same thing as ensuring that you have the ability to fully examine the allocation of assets, liquidity requirements, and risk management overall of an entire entity in the same way that depository institutions are.

Mr. KELLEY. So, if you are talking about asset allocation, like long-term dated Treasuries with respect to deposits, agreed. And that is not what we do. If you are talking about assets generated in our program and their ability to be repaid to the taxpayer without the guaranty being honored then we do have the authority.

Ms. DAVIDS. Okay, so I want to, I also want to follow up on some of the questions that Mr. McGarvey was asking because I will give you the benefit of the doubt. I think that you were responding to his question about lenders by talking about the borrowers and the need to reduce red tape, both on the borrower's side and on the lender side. Could you expand a bit on what you mean when you talk about the reduction of red tape? Because the request for less red tape from lenders is not the same thing as opening up the program for additional lenders that are not being regulated or overseen in the same way that depository institutions are. And I just want to make sure that I am fully understanding your response and real quick, because I have a feeling you will use the rest of the time, when it turns red, if you could just stop and make sure that it would not be more appropriate to follow up with a written response to the question you might find that the rest of the hearing will go a little bit smoother.

Mr. KELLEY. Agreed. And I want to apologize to Mr. Meuser for my Irish coming up, and I understand that we will be able to answer questions as we normally do, so. I am passionate about defending civil servants and the role that they have played in the pandemic, so I apologize.

So, with respect to your question about lenders, so what I am describing, and this is I guess important and I hope to leave you all here where we are in agreement is that for time in memorial, the subsidy calculation has incorporated the underwriting and collateral criteria and all that we have done is harmonize across a standard 7(a) small loan with an SBA Express term loan, that standard that more lenders have used historically every fiscal year. And so if the object of the exercise is to engage, for example, the 4,500 community banks more meaningfully. So it has been reported that 83 percent of those same 4,500 community banks did not make a single 7(a) loan in the 2 previous fiscal years prior to 2020 Paycheck Protection Program. So if we want them to meaningfully be available in their communities, we need to optimize the responsibilities——

Ms. DAVIDS. Can I stop——

Mr. KELLEY.—the criteria that they need.

Ms. DAVIDS. Can I stop you there? I absolutely recognize that. I just will add that some of the fintechs that we have been talking about are not subject to all of the rules and regulations in oversight that our community banks have been adhering to for a very long time.

With that, I will yield back.

Chairman WILLIAMS. I now recognize Mr. Ellzey from the great state of Texas for 5 minutes.

Mr. ELLZEY. Thank you, Mr. Chairman.

Mr. Kelley, thank you for being here. Howdy. How are you doing? Thank you for being here.

You have got a long history of service as a civil servant, and I understand that you want to defend the folks that you work with. That is highly admirable, and I understand that you went to Colgate and then BC Law. So you are an immensely talented man. You worked at a bank and, you know, Mr. Williams has been in business for, oh, a couple of eons, I think. But he has been a small business man for many, many years. My colleague from Missouri has as well been in business for a long, long time.

I have never heard Mr. Luetkemeyer get upset before and somehow you managed to do that. And I am not sure if I heard the answer or not but it is kind of a proforma question that we have been asking in all of our Committee hearings after the declaration that the COVID catastrophe is over. How many folks are going to work? Because it does not matter the Committee that we are on. You look across the street at a government building and there is generally not a whole lot of people there and the parking lots are empty, and I think that that goes directly to the service that the taxpayers who are paying for these services are receiving and oftentimes it does not really matter the agency that it is in. And you have got your rice bowl that you are worried about and not worried about any others. It does not matter if we ask DHS, HHS, or anybody else. We ask how many people are at work? Because Mr. Williams cannot run a car dealership if half of his people are not showing up. They cannot work remotely. And I do not think people get a good service if folks are not showing up to work.

So, when that question comes up, just understand it is not aimed at you or anybody else but the question as the oversight authority for all of these agencies, as the funding authority is Congress's for all of these agencies, the simple question is, how many people are at work? And it may be a different answer. You are clearly a talented attorney. Maybe the question is, what is the policy on how many people get to show up? I will let you answer the question, but my policy is I have to show up at work. We are not doing remote anymore. I do not think any of the other agencies in our government should be remote anymore because we are seeing a declination of service to the taxpayer.

So you have the floor now. What is the policy on how many people have to show up to work?

Mr. KELLEY. Yeah. So the policy is you have to—so I understand that we disagree with what I am about to characterize. But you have to show up to work. So every single federal employee has to show up to work. As far as telework, and telework policy, Chairman Williams mentioned that I worked at the Department of Commerce at the U.S. Patent and Trademark Office. That is a distributed workforce as well and has long had a telework policy in place in processing trademarks and patents.

We have a distributed workforce. Folks show up to district offices, loan production centers, as well as headquarters. And the policy today is that for each 2 week, biweekly period, you physically

need to come into the office 3 days out of that period. And so, for example, I worked at a bank that Chairman Williams suggested, and we did something unconventionally where we did not have branches. Most banks have branches across the country. We chose not to use branches which is a physical presence in a physical footprint, to lend money. And that has served Live Oak as a comparative advantage in terms of its cost structure to become the nation's number one small business lender.

So there are many different approaches to performing and optimizing how you deliver your service and your products. And so what I am arguing on behalf of the civil servants is that they are working hard I can attest to you. And as has probably been demonstrated and as you reflected, I expect that people perform as well as myself.

Mr. ELLZEY. Well, BC Law is a good law school. It is a simple question. It really is. Virtual presence is actually absence. When you are a civil servant you need to be in the office because otherwise you cannot be supervised properly. I do not care what business it is. I know some airlines I will call up the customer service line and I will hear dogs barking in the back and I know they are not at work and I am not getting good service. I think it is expected by the taxpayer that civil servants be exempted from a private company. They are not like a private company. A private company can do whatever it wants. Civil servants need to be showing up for work. So is there a percentage in your policy that says how many people have to be at work every day? Does it exist or not?

Mr. KELLEY. One hundred percent of policy without supervisor approval of leave of absence, you know, scheduled vacation, sick days, et cetera, have to show up to work. And there is a telework policy in place which I have explained the contours of.

Mr. ELLZEY. All right.

Mr. KELLEY. And you need to comply with that.

Mr. ELLZEY. Okay. Well, I am almost out of time so I am not going to get the answer but, you know, folks need to be showing up in the office at work. We are seeing across the government an inability to effectively accomplish the job on the part of the taxpayer. But I thank you for your time and I yield back.

Chairman WILLIAMS. Thank you.

I now recognize Ms. Gluesenkamp Perez from the State of Washington for 5 minutes.

Ms. PEREZ. Thank you, Mr. Kelley, for joining us here today.

As a former small business owner, who successfully applied for a 504 Loan, I know that small business owners want streamlining when it comes to SBA programs. We do not have time to waste reading SBA regs.

As part of the new SBA affiliation rule, the rule removes the detailed list of factors that the SBA currently utilizes when determining whether a loan applicant is credit worthy. Could you speak to the intent behind this rule?

Mr. KELLEY. Yes. So the thing I would like to clarify, too, is affiliation is used for two purposes in underwriting alone historically at the SBA. And in the conventional commercial market affiliation is used solely for reasonable reassurance and repayment. So the impact of any affiliates to cashflow. Okay?

In our programs today, tomorrow, and forever, the impact of an affiliate to cashflow remains and will continue to be the responsibility of lenders to look at. With respect to eligibility, which is a uniquely government requirement that the business be a small business based on SBA's size requirements, historically the agency took the position which we believe weas a red tape bureaucratic position which is the business needs to be independently owned and operated and it chose to construe independently owned and independently operated as two separate clauses as opposed to, say, a non-severable clause like cruel and unusual punishment.

So what we are applying and what we saw work in the Restaurant Revitalization Program and the COVID EIDL program to a varied degree in the Paycheck Protection Program is a standard ownership test. So you know who owned your business. If I asked in the community who owns your business they would tell me to see you and the buck would stop with you. What was happening with the affiliation is that a subjective criteria of totality of the circumstances to determine whether third party management agreements that you entered into, you the small business owner enter into, creates negative control deemed by a federal government employee. So the federal government will tell you who controls your business based on the agreements that you have entered into with a third party.

We believe that that is wrong. And so we took the position that independently owned and operated should be viewed like cruel and unusual punishment as a nonseverable cause for the purpose of determining eligibility because size standards, meaning total number of employees for certain NAICS codes, revenue standards for others, and in the loan program since 2010 when Ranking Member Velázquez passed the Small Business Jobs Act, includes the alternative size standard. And we found in both the government contracting division and in these loan programs is that even accounting for affiliates in eligibility, the businesses are still considered small.

So if the definition of removing red tape and bureaucracy is to remove that, that is what we are doing. But with respect to whether or not we will get paid back as taxpayers, the requirement for affiliated analysis remains as it always has been.

Ms. PEREZ. Thank you.

Mr. Kelley, if a small business owner is denied a loan they can request reconsideration?

Mr. KELLEY. Mm-hmm.

Ms. PEREZ. The affiliation rule extends the list of people who can consider the reconsideration request and make a final decision to include the designated director of the Office of Financial Assistance and the SBA Administrator. Are there guardrails in place to ensure that these changes were not subjected in the consideration process?

Mr. KELLEY. Yes. But I think what we should understand is that that rule was exactly responding to public concerns on the part of both lenders and borrowers that the process, by requiring it go all the way to the top of the House each time led to, you know, delays. And so this gives us the discretion to let the folks who, you know, we have talked a great deal about, the civil serv-

ants at work, to make those decisions based on their experience. So you will get a faster response.

But in terms of the process, there are second look processes. You know, to the extent that people are trying to influence things, there is, as you all know, anonymous hotlines for tips to the IG and so forth. And those are all, you know, functional.

Ms. PEREZ. Sorry. So could you describe those guardrails a little bit more in detail?

Mr. KELLEY. Yeah. So the process as outlined, so for example, when the IG talks about its risk management challenges for anything, it starts with are there identified roles of who is responsible? What steps have to take place? Did those steps take place? And was there a second look process to ensure that there is not the discretion of a single individual. And those processes are outlined in the SOP. The roles, the whole, and then the second look aspects of it.

Ms. PEREZ. Okay. Thank you.

Mr. Chairman, I yield back.

Chairman WILLIAMS. Also, let me remind all Members to turn their mics on when they need to.

I now recognize Ms. Salazar from Florida for 5 minutes.

Ms. SALAZAR. Thank you, Mr. Chairman. And good to talk to you, Mr. Kelley. My name is Maria Salazar. I represent the City of Miami where SBA is like the crown jewel. People really think that this agency is really cool.

And ever since I got to the Committee 2 years ago, my first term, I had the honor of taking Administrator Guzman to my district. I am not sure if you are aware of that trip. I took her to Eighth Street. She was able to see, although, small businesses, the drycleaner's, and the flower shops. And people that look at the SBA as the crown jewel.

You said that you are a political appointee, so that means that you know what the private sector looks like and how it works. And you said that you were a nerd. So nerds in the private sector usually do well meaning that they have, they can make a good name for themselves.

So I just want to share a couple of ideas and then ask you three questions. We are very disappointed with the SBA. And we are trying to figure out how we can make this agency better for the average American small business owner. So I am going to ask you a couple of questions and I want you to answer me as if I were that let's say Indian American who wants to set up this drycleaners and he needs a small little help from the SBA because, you know, that is the American dream. And he tells you, look, I have called 10 times. The online service does not really work. I have uploaded my information seven times. Every time I call I talk to somebody else and it is very difficult for me, the Indian American wanting to set up this drycleaner's to get to the finish line and get the money. You are telling me and from the information we have is that now the SBA has 30 percent less personnel. When I spoke with Administrator Guzman she told me that she was going to improve the online services, the people, the operators, the people on the other side. That it was going to be streamlined and that service was going to look beautifully.

My question to you is this. Tell me one thing that you are proud of in this last 12 months that you and Administrator Guzman have established and instituted to help this Indian American to get his loan so he can open up that drycleaner's in simple terms.

Mr. KELLEY. Yes. So first, I just want for your use case because I assume it is a constituent. That constituent should find a different lender because we work through third-party lending intermediaries. So if you are seeking a small business loan in either the 7(a) or the 504 program and you are having those issues that you have described, there are plenty of banks and credit unions across the state of Florida, I am sure in the city of Miami and certainly nationally, that they should go to.

Ms. SALAZAR. But sometimes they do not want to touch that person and that person needs to go straight to the federal government. The SBA, that is what we are there for.

Mr. KELLEY. Yes. So——

Ms. SALAZAR. So let's suppose that he does not want to be touched because he is too small. We have to provide a good service and we are not. So go back. So do you agree with the fact that the agency that you are helping to run is not providing the service that the average small business owner believes; yes or no?

Mr. KELLEY. So are you recommending that the Office of Capital Access and SBA take advantage of the authority we are afforded until the Small Business Act, section 7(a) to do direct loans as a final chance credit not available elsewhere?

Ms. SALAZAR. Sometimes that is the last resort that person has.

Mr. KELLEY. Okay. So in order to do, so the Agency has not done direct loans in its 7(a) program or general business——

Ms. PEREZ. But I am talking about what you are proud of is what I am saying. What is it that you have in the last 12 months, along with Mrs. Guzman established in order to redress some of the problems that I just mentioned which are endemic?

Mr. KELLEY. Yes. So what we would be proud of is the rules that we have talked at great detail in this conference because to the extent that the use case you are describing is struggling with their bank or credit union or nondepository lender and having that terrible experience that you described, we want to take off the sidelines more credit unions and banks. So, for example, credit unions are thousands of depository institutions across this country——

Ms. SALAZAR. I am sorry I am interrupting. So you are telling me that they are going through your online system, when they are going through your computer system, when they are going through your staff——

Mr. KELLEY. That is what I am trying to clarify. The way that the program is set up, there is a waterfall under Section 7(a) of the Small Business Act which says that you should seek a conventional loan first. If you are not able to seek credit not available elsewhere, you can go to a participating lender for a loan guaranty. And so we work through that lending—all of the interactions, all of the online, the call center that you are describing, the experience is governed by the individual lender. If we were to use our authority for direct lending which we have under Section 7(a)——

Chairman WILLIAMS. Your time is up.

Ms. SALAZAR. We will get back to you on that because that is not my experience. Thank you.

Chairman WILLIAMS. I now recognize Ms. Scholten from the great state of Michigan for 5 minutes.

Ms. SCHOLTEN. Thank you, Mr. Chair. And thank you, Mr. Kelley. Hillary Scholten from Michigan's 3rd Congressional District. Wonderful small businesses throughout the region.

I think that the theme of today is oversight. And the importance of providing oversight to these nuanced rules. A lot of my questions and concerns have been covered here today so I am not going to repeat them but I do want to add my voice to those saying just how critical it will be for our Committee to continue to provide the necessary oversight. I have heard from financial institutions again and again just how concerned they are about the implementation of these rules.

My question for you is, the SBA has repeatedly said that these rules will increase small dollar loans and expand access to capital for underserved communities. Can you go more in depth on the success of the Community Advantage Program and why the SBA chose to create this new type of SBLC and what sort of was the genesis there? Thank you.

Mr. KELLEY. Yeah. So, if we build off of your colleague, Representative Salazar's example where in that case she was describing an Indian American drycleaning small business seeking a small dollar loan amount and being frustrated by the third party lender's customer service experience, et cetera. We need a wider distribution channel so that that person does not have to rely solely on one lender. They can go to the entire marketplace. And historically, certified development financial institutions were not eligible to participate in the 7(a) programs. So beginning in 2011, under the Obama administration, we temporarily lifted the moratorium so you are allowed under pilots to waive regulations. So we lifted the moratorium, issued temporary licenses. And we did that to experiment for safety and soundness reasons, but to experiment that those lenders who were embedded in communities where, for example, there are 1,700 banking deserts across rural and urban areas where there is not a bank branch within a 10 mile radius but there are CDFIs. And so the theory was if we have a diverse array of distribution channels, using the same core product that is ultimately beneficial to the lender and borrower. It is beneficial to the borrower because they get a fixed rate, they get a capped rate product and longer repayment terms with no prepayment penalties. That longer repayment period is good for the lender as well because it qualifies more loans. And then the backstop of the government guaranty in the secondary market helps them manage liquidity.

So 7,000 loans have been made during that pilot for a billion dollars, and the distribution for underserved, including rural, HUBZone, veteran, small business, a business startup in business less than 24 months, that criteria for underserved has been met, you know, I think 60, 70 percent of the time.

And incidentally, as was mentioned in the Senate hearing, our core product, whether it is a dollar loan or a $5 million loan over indexes in comparison to the commercial market to that same definition of underserved but we have seen a gap for women-owned

businesses who make up a sizeable percentage of sole proprietors and yet, a single digit percentage of loans received through the SBA program. And it is in part because the census shows that those businesses are overwhelmingly sole proprietors, which means they are seeking very small dollar amounts, loans less than $150,000. And when you talk to a community advantage lender, you talk to a bank like JPMorgan, Chase, TD or large banks and you ask them why is there a disconnect? The disconnect is the cost-effectiveness of being able to underwrite and close the loan. And so we have responded by addressing the red tape that they have identified so that they can make a more cost-effective offering because we believe, and we take them at their word, that they will find these customers in their marketplace.

Ms. SCHOLTEN. And have the results been borne out?

Mr. KELLEY. Well, yes, in terms of, so the community advantage programs results over index in the underserved category even in comparison to a high number. And then with respect to minorities and women, it performs better. So, yes.

Ms. SCHOLTEN. I yield back my remaining time.

Chairman WILLIAMS. I now recognize Mr. Crane from Arizona for 5 minutes.

Mr. CRANE. Mr. Kelley, thanks for joining us today. You probably do not know this. I am a small business owner myself so I definitely understand how tough it is to start a small business, pay employees, you know, deal with an everchanging economy. Do you know how I got my startup capital for my business, sir? I sold my motorcycle. Yeah. One of the best decisions I ever made.

Sir, are you aware that Pew Research shows that 20 percent of the American people do not trust the federal government?

Mr. KELLEY. I am not.

Mr. CRANE. Okay. Well, they do not. And I think that if you polled this cross section of our citizens today you would probably see something similar.

Sir, are you aware, yes or no, does the American taxpayer fund the SBA?

Mr. KELLEY. Yes.

Mr. CRANE. Okay. Does the American taxpayer—hold on. Hold on a second. Does the American taxpayer fund your salary, sir?

Mr. KELLEY. It does.

Mr. CRANE. Okay. Mine, too, as well; right?

Mr. KELLEY. Yes.

Mr. CRANE. All right. So, sir, Mr. Kelley, who is on the hook if these loans are defaulted on?

Mr. KELLEY. So that is what I was going to explain with my exception. So, with respect to supporting the loan programs, and this is a really cool thing for you and all of the folks that might be——

Mr. CRANE. Real quick, sir. Real quick. My time is running.

Mr. KELLEY. The fees and the collection from liquidated collateral creates a profit for the federal government that enables us to waive fees for the borrowers and lenders and not ask for appropriate dollars at SCORE in order to support the 7(a) and 504 programs.

Mr. CRANE. Hold on a second. All right. First of all, the federal government does not make a profit. I think most people here are smart enough to know that. Do you guys know how much national debt we are in right now, anybody? Almost $32 trillion of national debt. Okay. So this government does not make a profit. As a matter of fact, it continues to spend money, upon money, upon money that we do not have. It just continues to print money that we do not have. And that is my problem here, Mr. Kelley. This town, these administrations that make up this town, the lobbyists, the special interests, are notorious for being poor stewards of the American taxpayer dollars. And now you are trying to implement changes to these loan programs to make it easier to lend people money that we do not even have. That is the problem. And it is for that reason, and because of the debt, the times that we live in, in our history in this town, in this government of showing zero fiscal responsibility that I do not support these changes and I do not think they are appropriate.

I yield back my time. Thank you.

Chairman WILLIAMS. Okay. I now recognize Mr. Phillips from Minnesota for 5 minutes.

Mr. PHILLIPS. Thank you, Mr. Chairman.

Welcome, Mr. Kelley. I want to start by thanking you. I know there are lots of things you could be doing with your life other than this, and I want to thank you for your service.

I do a series in Minnesota called On the Job with Dean where I visit small business and work a shift for 2 or 3 hours and have learned a ton, the good, the bad, the ugly about the SBA. But mostly the good as a resource, as a provider of capital, and also mentorship. And I want to thank you for what you do.

Just last week I was in Eden Prairie, Minnesota visiting the Asia Mall, which is a converted big box store, an extraordinary place. Administrator Guzman and a second gentleman came to visit. I worked a shift as a stockboy and a cashier and once again saw SBA loans creating a wonderful story of success in my district.

And I also am a deep believer in shared success, in employee ownership. And have been trying to push both this Committee and my colleagues to look at ways where we can build bridges to more shared ownership. Our Ranking Member has a wonderful bill. I will be introducing one next week as well, and I want to focus on that. I know some of the changes, at least in the recent past, the 7(a) has only financed about five employee ownership changes in control. I know under the affiliation lending criteria rule now partial buyouts will be allowed under 7(a). So if you could just speak to how you think that might increase access to capital for employee ownership and any comments you might have.

Mr. KELLEY. Yes. And not to pour salt in the wounds, but the forthcoming SOP will have delegated authority for ESOP transactions. So I did want to mention that.

So with respect to partial buyout, the reason that this was put in here is to affect employee ownership. And historically what is challenging about an ESOP is that it is a formal process that requires role-based compliance. So, a fiduciary, a designated employee to take time away from, you know, doing the duties of a

stockboy as you suggested to perform their roles to stay in compliance with the regulations governing that.

So it works for a certain size company. It does not work for what President Biden has characterized as the Mom and Pops or the smallest of the small. So, what partial buyout does is it builds off of a process that has worked well for 7(a) lenders, which is change of ownership. A third of all SBA loans are either full partner buyouts or full stock or asset purchases today. This is a transaction that they do a lot of. And so now, today, an existing ownership can dilute their common stock ownership to their employees and the business's cashflow can pay for that transaction. And of course, all parties with 20 percent or more of stock in the company will remain on the hook with an unconditional personal guaranty.

So we believe this transaction will be cost-effective. It will be one familiar to our core lenders and they will originate more details that way.

Mr. PHILLIPS. Okay. Are there any other structural barriers that you think could be addressed to further increase availability of resources for ESOPs?

Mr. KELLEY. So, we looked at ESOPs when I was lending, so I built out a lending division prior to the last role that was referenced and did about a half billion of lending. And we looked at ESOP transactions. They actually have very favorable benefits if, for example, you are a defense contractor. Okay? So, cost plus and things like that for reimbursement. But for the core businesses that are in your districts, the transaction costs were too high for the seller and the time it took to affect the transaction meant for a lender that, you know, we needed to move on to originate more loans. And really, everything about a lender, and this is good or bad or however you want to look at it, is I have got to meet my quota for that quarter and I have got to hit that bonus at the end of the year. And so I have to move on a timely basis.

Mr. PHILLIPS. Okay. I appreciate it. A couple of quick questions.

With turmoil in the banking sector, have you noticed any hesitancy amongst lenders in recent weeks, months, as it relates to 7(a)s?

Mr. KELLEY. Well, it was cited that, you know, the lending is on track for about $14 billion today. I think there is no question, the Fed has reported this, it is in whatever periodically you consume each day, that there is going to be a tightening of the credit box. Now, in SBA lending, a tightening of the credit box normally means that this is a tool that becomes, you know, more handy, right, for the lenders. And the challenge, and I really want to reiterate why we are doing all these changes. In 7(a) lending today there are 20 lenders doing 50 percent of the lending nationwide every year.

Mr. PHILLIPS. Can you say that again?

Mr. KELLEY. Twenty lenders do 50 percent of the lending. So, a nation that has 33 million small businesses, because of the red tape and bureaucracy that we are removing but historically has been in place, has supported 20 lenders. And, you know, I have called myself a nerd here so I will take another. It needs nerds like me at the bank to comply with the rules. So we are trying to level

the playing field so that we can get 4,400 banks and thousands of credit unions off the sidelines into using these programs.

Mr. PHILLIPS. Thank you. My time is expired so I yield back. Thank you, Mr. Kelley.

Chairman WILLIAMS. Okay. I would like to thank our witness for your testimony today, for appearing before us today. I think you see this Committee is bipartisan. We want the best service out of the SBA that we can get.

Without objection, Members have 5 legislative days to submit additional materials and written questions for the witness to the Chair which will be forwarded to the witness.

I ask the witness to please respond promptly, and you have been asked to do that today.

So if there is no further business, without objection, the Committee is adjourned.

[Whereupon, 11:33 a.m., the committee was adjourned.]

APPENDIX

Testimony Prepared for SBA Associate Administrator Patrick Kelley
U.S. House Committee on Small Business
Hearing on Examining the SBA's Changes to the 7(a) Lending Program Part I
May 10, 2023

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

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

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

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

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

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

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

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

In November 2022, SBA published proposed rules to revitalize the Small Business Lending Program and streamline the affiliation rules for SBA loans. Both of these rules were open to

public comment for 60 days and SBA has diligently worked through all of the public comments we have received.

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

SBLC Rule

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

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

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

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

Affiliation Rule

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

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

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

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

Criminal History Records Rule

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

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

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

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

House Committee on Small Business Hearing
May 10, 2023
Follow-Up Questions for the Record for Mr. Patrick Kelley

Questions from Chairman Williams

1. The S-B-A's Office of Inspector General has found that many non-depository lenders in the 7(a) program were subject to "limited oversight until a default occurs and identified significant issues within the agency relating to lender oversight. The Inspector General also noted a failure of the S-B-A to conduct regularly scheduled examinations over high-risk lenders. In short, the O-I-G has reported on many issues that questions the Agency's ability to be a regulator.

   I share these serious concerns. And late last night, the S-B-A released a policy notice for just one of the final rules to lenders that will help them implement these new rules. It appears that for loans under $500,000, the agency removed almost all underwriting criteria and lenders are allowed to give out loans however they see fit. Carving out smaller loans from any standard underwriting requirements is one of the worst ways to mitigate risk and will increase the chances of predatory lending on small businesses.

   The agency is brining on more lenders and diminishing underwriting standards at a time when the Agency is already failing to conduct all the necessary oversight over high-risk lenders. This is a recipe for disaster. **Mr. Kelley, what percentage of the current 7(a) loan portfolio is under $500,000 dollars, and how will the S-B-A monitor the many different underwriting models that will be used by lenders since you took away the uniform standard?**

   For FY2022, SBA approved 35,031 loans less than $500,000, which is 73% of total 7(a) loans. That equates to $5,351,385,100, or 21% of the total 7(a) dollars lent in FY2022.

   OCRM will review the credit policies of each lender as part of the ongoing risk-based review process. The loan files reviewed for each lender will be monitored for compliance with the lender's credit policy and prudent lending criteria as determined by SBA. Concerns will be communicated to the lender and corrective actions required to ensure their compliance.

2. In a letter my Senate colleagues sent you in March, you stated that the S-B-A has the same standards as all other federal regulators relating to the Bank Secrecy Act and other Know Your Customer and Anti-Money Laundering requirements. I have been told this simply isn't true, so I would like you to set the record straight. **Can you confirm that that the S-B-A does in fact require all SBLCs to comply with BSA and KYC regulations, and where can I go to see the guidance that you give to lenders on how to comply with these requirements?**

   Small Business Lending Companies (SBLCs) participating in the 7(a) lending program have been subject to Bank Secrecy Act (BSA) requirements for almost 20 years. In 2001, Congress enacted the USA PATRIOT Act (P.L. 107-56), which amended the BSA to require

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

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

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

SBA has been testing lender compliance with these requirements through Targeted Reviews and will continue to do so during the regularly scheduled risk-based reviews performed on all SBA Supervised Lenders. Additionally, with respect to PPP loans, at the time of guaranty

purchase, SBA may review an SBLC's compliance with the BSA underwriting requirements applicable to PPP loans.

3.

The credit elsewhere test that is the hallmark of the 7(a) program. The S-B-A is supposed to be the lender of last resort and it would be unacceptable to make this government agency as direct lender to compete with the private sector. Mr. Kelley, why has the S-B-A been silent on the credit elsewhere test in everything that has been released thus far?

SBA continues to enforce the statutory requirement that small business applicants are unable to obtain credit on reasonable terms from non-SBA guaranteed sources per Section 7(a)(1)(A) of the Small Business Act and its implementing regulation at 13 CFR 120.101.

Proposed questions from hearing:

1. **How will the SBA monitor if the 'credit elsewhere' test is being satisfied to ensure the SBA remains the lender of last resort?**

   The Administrator has the authority to direct and conduct oversight for the methods by which lenders determine whether a borrower is able to obtain credit elsewhere. These instructions are provided in SBA's Loan Program Requirements.

2. You have previously claimed these rules changes are necessary because 7(a) lending is down. However, looking at SBA's own published data, that statement is incorrect. SBA lending in 2022 was the second highest level ever recorded. **How come your rhetoric does not match up with the data your own institution provided?**

   The rule changes are necessary because of a multi-year trend in the decrease of small-dollar lending across SBA loan programs. Several metrics highlight this decline, including:

   - A dramatic increase in average 7(a) loan size, from $263,000 in FY2010 to $705,000 in FY2021.
   - A drop off in lending under $150,000, from 38,000 7(a) loans of that size in FY2016 to around 18,000 in FY2021.

   Additionally, the rule changes will address capital gaps for rural businesses, minority-owned businesses, very small businesses, and start-ups.

3. **How will the SBA monitor if the 'credit elsewhere' test is being satisfied to ensure the SBA remains the lender of last resort?**

   See the response to Question 1 above.

4. **You spoke about the need for these changes so more underserved communities could access capital. However, the final rule stripped out all mention of underserved communities. Why is that?**

   SBA has provided additional guidance through SOPs which explain that a minimum of 60% of the number of CA SBLC loans closed must meet the underserved market requirements currently in place for the CA Pilot Program.

5. **Do you think it is important that the SBA maintains its position as the lender of last resort?**

   Yes. SBA remains committed to ensuring that its programs provide loans to small businesses who are unable to access capital through conventional sources.

   Follow-up: Do you think the SBA should start competing with banks and go into direct lending?

   SBA works with private sector financial institutions to help small businesses access capital. SBA will continue to explore strategies to expand access to capital, particularly to underserved communities.

6. **The Treasury Department issued a report in December of 2022 that called fintech's predatory and likely to take advantage of underserved communities. How did the SBA come to the complete opposite conclusion?**

   SBA follows a risk oversight framework for all its lender participants. In the case of Community Advantage Pilot Lenders, Community Advantage SBLCs, SBLCs, and other non-bank lending participants, which are not subject to the same regulatory approach as the general banking system, SBA's oversight provides assurance that the lenders do not take unsustainable lending risks, that they comply with SBA's Loan Program Requirements (as defined in 13 CFR 120.10), and do not apply abusive tactics to borrowers. SBA regulates interest rates, loan terms, and permissible fees that prevent high interest predatory lending practices in SBA programs. If a lender were to violate these requirements, SBA has the authority to take informal or formal enforcement action, including revocation of program participation.

7. **The House Select Subcommittee on Coronavirus Crisis Report on fintech Fraud in PPP warns SBA that "Any Plans by the SBA to Again Open 7(a) Participation to fintechs and Other Unregulated, Non-Depository Institutions Must Be Accompanied by a Well-Defined, More Rigorous, and Better-Resourced Initial Review Process, and Such Entities Should Be Subject to Continuous Monitoring to Confirm Their Adherence to SBA Rules and Industry Best Practices." What changes have been made since this report was released?**

   The criteria used to evaluate prospective PPP lenders differs from the criteria used to assess SBLC applications.

SBLC Application Requirements:

The entity applying for a new SBLC license must submit an executed electronic scanned copy (in pdf format) to SBLCApps@sba.gov addressing each of the elements set forth below (SBLC Application). The SBLC Application must be complete and organized in tabular format. The application must include:

1. The Legal name, address, telephone, and email address of the proposed SBLC;
2. Identification of the form of organization of the proposed SBLC along with file-stamped copies of the concern's certificate of incorporation, certificate of formation or certificate of limited partnership (as applicable), and a copy of the concern's corporate bylaws, limited liability company operating agreement, or limited partnership agreement (as applicable);
3. Identification of the proposed SBLC's capitalization including the form of ownership, the identification of all classes of equity capital and proposed funding amounts, rights and preferences accorded to each class of stock or members interest (including voting rights, redemption rights, and rights of convertibility) and conditions for transfer, sale, or assignment of these interests;
4. The proposed SBLC's geographic area of operation;
5. Identification of all officers, directors, managing partners, managing members, and Key Employee(s) of the proposed SBLC, which includes senior managers, members of loan committees, and individuals who have a meaningful participation in the direction of the operations, policies, or financial decisions of the proposed SBLC), and all other individuals or entities that propose to hold an equity interest of at least 10% of the economic interest in any class of stock or ownership interest in the proposed SBLC (such identification should include a discussion of any prior SBA experience);
    i. An organization chart showing the relationship of the proposed SBLC with all related Associates (see Appendix 3, Definitions) and affiliates within the organization;
    ii. All individuals or entities identified in this paragraph must submit an executed SBA Form 1081 and either a Form FD–258 (fingerprint card) or Electronic Fingerprint Submission. SBA Form 1081 and the Form FD–258 or Electronic Fingerprint Submission must be signed and dated within 90 days of submission to SBA.
    iii. A director or Key Employee of the lender organization is only required to submit either Form FD–258 (fingerprint card) or Electronic Fingerprint.
    iv. Submission if the director or Key Employee answered affirmatively to questions 10a, 10b, 10c, 11a and/or 11b on the SBA Form 1081. For SBLCs, proof of fidelity insurance coverage as detailed in 13 CFR 120.470(e).
6. A comprehensive business plan that details:
    i. The nature of proposed operations, including the organizational units involved in sourcing, evaluating, underwriting, closing, disbursing servicing, and liquidating small business loans in the organization;

   ii. The identification of all sources of capital used to finance lending operations;
   iii. An operations plan detailing the nature of the Lender's proposed loan activity, the volume of activity projected over the first three years as an SBA Lender, projected balance sheets, income statements and statement of cash flows of the Lender, with alternative profit and loss scenarios based on run rates equivalent to 70% and 50% of projected loan activity, the type and projected amount of financing needed to support its lending plan, along with a discussion of Lender's proposed wind-down plan in the event the Lender decides to leave the program;
   iv. A detailed analysis of the Lender's projected secondary market activities during the first three years of operation, including a sensitivity analysis of the effect any changes in premium from the sale of the guaranteed portion of 7(a) loans in SBA's secondary market may have on the Lender's prospective earnings. The analysis must also include a description of the Lender's plans (if any) to securitize or sell participations in the unguaranteed portion of 7(a) loans; and
   v. If the Lender intends to acquire any 7(a) loans, a written plan detailing the extent of this acquisition activity in its operating plan, and how the Lender will manage the transition of the 7(a) loan portfolio;
7. All documents associated with any type of external financing expected to be undertaken by the proposed SBLC;
8. A written statement from an authorized official of the acquiring concern certifying that the SBLC will not be primarily engaged in financing the operations of an Affiliate as defined in 13 CFR 121.103.
9. The most recent audited financial statements of the acquiring concern if it has been in operation for more than one year, or the audited financial statements of the acquiring concern's parent company.
10. A certified copy of a Board, limited partners, or members resolution specifying the individual(s) or official(s) granted the authority by the organization to submit this SBLC application;
11. A certification by the proposed SBLC that it is in full compliance with all Federal, State, and local laws;
12. A written legal opinion of independent counsel (''Independent Counsel'' is counsel that is not an Associate of the lender), satisfactory to SBA that addresses whether the proposed SBLC:
   i. Is duly formed, organized, and validly existing in good standing under the laws of the State of its organization, and is in full compliance with all Federal, State, and local laws in connection with the formation and organization of the proposed SBLC; and
   ii. Has the power, legal right, and authority to enter into the Form 750 Agreement.

OCRM uses technology tools to monitor the performance of all participating lenders, including SBLCs. These include the Loan and Lender Monitoring System (L/LMS), the

annual validation of the loan scoring model, and the internal control policy referenced in the FR Notice (88 FR 32623, May 22, 2023).

8. Fintech lenders do not have to be transparent about the interest rates they are offering for various loan products. **How will the SBA determine if these entities are properly accounting for the 'credit elsewhere' test?**

   All lenders in SBA's programs must be transparent about the interest rates that they charge and all of the fees are disclosed to the borrowers in the terms and conditions of the loan. SBA plans to use the established risk-based review process, described in response to Question 3 and Proposed Questions 1 and 3 from Chairman Williams.

   Follow-up: Would you support a bill requiring fintech companies to disclose the interest rates of their other loan products if they want to participate in the 7(a) loan program?

   It is critical for all SBA lenders to be held to the same standard. SBA would be happy to discuss a bill regarding certain financial disclosures for all SBA lenders with Congressional staff to explore opportunities to better support small businesses.

9. **Fintech companies can create algorithms to adjust their underwriting standards at almost any time. How will the SBA know if this has occurred and to ensure there is not more risk being secretly added to the government-backed portfolio?**

Loan specific risk is measured as loans are booked. These are reported in the Lender Portal and to OCRM in monthly and quarterly reporting. OCRM closely monitors the risk metrics to identify and mitigate emerging risk.

10. **Some fintech companies who participate in the program do not offer commercial loans. How will these companies be able to reference similar loans as they attempt to underwrite 7(a) loans?**

    All non-bank lenders including SBLCs are required to submit their credit policies to SBA for review. If their policies are considered inadequate, SBA will require that any deficiencies be mitigated before allowing the lender to participate in the SBA loan program.

    SBA also considers risk factors in its evaluation of new SBLC and other non-bank applicants. These factors include, but are not limited to:

    - The lending policies of the proposed SBLC, including those for non-SBA loans, and their alignment with SBA's mission;
    - Historical performance measures (such as default, purchase and loss rate);
    - Whether the applicant is subject to any legal proceedings, enforcement action, order or agreement with a regulator or the presence of other related concerns;

- Other performance data associated with the acquiring concern or its senior management team, along with other relevant information (such as SBA observed gaps in small business lending not served by the existing 7(a) Lender population, including small-dollar lending and loans to underserved populations); and
- Affiliation with lenders or lender service providers previously sanctioned by SBA.

11. The Administrator responded to a March 20th letter to the Senate Small Business Committee that stated the SBA applies the same safety and soundness measures to all non-bank lenders as other federal regulators. **Can you tell me where I should go look for SBA's existing guidance to 7(a) lenders and SBLCs on how the agency evaluates compliance with TILA, usury laws, ECOA, and the Gramm-Leach Bliley Act?**

    As a federal regulator of the 7(a) and 504 loan programs, SBA applies safety and soundness measures to all non-bank lenders, including SBLCs, through the Portfolio Performance, Asset Management, Regulatory Compliance, Risk Management, Special Items (PARRiS) and Solvency and Financial Condition, Management and Board Governance, Asset Quality and Servicing, Regulatory Compliance, and Technical Issues and Mission (SMART) risk frameworks. SBA will apply the same oversight to new SBLCs. Please see SOP 50 10 6, Part 2, Section A, Ch. 3 Para. C, which states, "*SBA requires all participating SBA Lenders, including SBLCs, to comply with the U.S. Department of the Treasury regulations for Customer Identification Programs (CIP) for banks, savings associations, credit unions, and certain non-federally-regulated banks found at 31 CFR § 1020.220.*"

    a. **Follow-up: Can you confirm that SBA requires SBLCs and all 7(a) lenders to specifically comply with Bank Secrecy Act/Know Your Customer/Anti-Money Laundering standards, that SBA's examination guidelines outline how SBLCs will be reviewed for BSA/KYC/AML protocol, and that SBA has policies on enforcement and monitoring of these standards?**

       Please see the answer to Question 11 above.

    b. **Follow-up: Has OCRM had any enforcement actions with SBLCs since your time with the Agency who have not complied properly with these consumer protection laws, or, if no enforcement actions have been taken, how SBA has identified that all existing lenders, including SBLCs, are complying with these consumer protection laws?**

       SBA loans are business/commercial loans, not consumer loans.

12. **What is the average turnaround time when a current SBLC contacts the SBA with an issue?**

The Office of Capital Access (OCA) is responsive to questions, concerns, and issues from lenders and borrowers. Our goal is to respond to inquiries within 24 hours. Like all lenders, SBLCs have direct access to SBA's OCA departments that include policy, servicing IT/technology, and oversight.

13. The SBA Office of Inspector General believed it was problematic that there has been a 30% decline in SBA staff responsible for overseeing the 7(a) program and that technology cannot fill the gap. **How do you anticipate satisfactorily overcoming this burden?**

OCRM continues to provide effective oversight of the lenders participating in SBA's business loan programs. OCRM currently has 29 FTEs and plans to hire more staff in the coming months.

We also have five experienced contractors through staff augmentation, one Presidential Management Fellow, and four Employees voluntarily detailed from other offices within the SBA on an as-needed basis to support OCRM while permanent positions are being recruited for and filled. In our experience, these staff provide exceptional support to the existing review teams.

In terms of results, OCRM performed over 800 risk-based reviews and safety and soundness exams each year during FY 2021-2022. This is a record number of risk-based reviews and safety and soundness exams. SBA anticipates matching or exceeding 800 risk reviews in FY 2023.

14. What happens when the 7(a) program does not collect enough fees from the program to cover the amount of defaulted loans?

If the program does not collect enough fees to cover the amount of defaulted loans net of collections, then the program will have an upward reestimate. Conversely, if the program collects fees that exceed the amount of defaulted loans net of collections, the program will have a downward reestimate. A reestimate is an annual recalculation of the program cost based on actual program cash inflows and outflows as well as updated program performance estimates. An upward reestimate results in a transfer of cash from Treasury to SBA to cover the higher-than-expected costs. A downward reestimate results in a transfer of cash from SBA to Treasury to return the excess funds due to lower-than-expected costs.

Upward reestimates are covered by permanent indefinite appropriations in the program account.

15. The OCC has defined 9 categories of risk for bank supervision purposes. How many does the Office of Credit Risk Management look at?

To monitor lender performance, the SBA uses two composite risk-based review

measurement methodologies and scoring guides: the Portfolio Performance, Asset Management, Regulatory Compliance, Risk Management, Special Items (PARRiS) Lender Risk Framework for 7(a) Lenders; and the Solvency and Financial Condition, Management and Board Governance, Asset Quality and Servicing, Regulatory Compliance, and Technical Issues and Mission (SMART) Lender Risk Framework for 504 Lenders. These risk frameworks, developed to mirror those used by the primary federal regulators to manage risk among their member institutions, use portfolio metrics to analyze risk and identify emerging trends.

SBA monitors portfolio risk at the loan and lender level through the Loan and Lender Monitoring System (L/LMS), which tracks monthly performance by lender and assesses quarterly credit scores for all 7(a) and 504 loans. The data provided by the L/LMS and other systems help the SBA to assess the risk of the SBA loan portfolio of each 7(a) Lender, CDC, and Microlender Intermediary. They also help identify SBA Lenders whose portfolio performance or other lender-specific risk-related factors demonstrate the need for additional monitoring.

a. **Follow-up: How does the OCRM determine liquidity risk for SBLCs?**

   SBA applies capital requirements during its quarterly and annual financial statement reviews to determine whether SBA Supervised Lenders have adequate liquidity.

b. **Follow-up: How does the OCRM determine interest rate risk for SBLCs??**

16. The rules allow for the Administrator to set the reserve levels and loan loss reserves levels for SBLCs. **Why did the SBA choose to move forward with an inconsistent, patchwork approach rather than pushing for one uniform standard?**

    The SBA rules aim to provide flexibility that would address volatile markets and adjust based on lender performance for loss reserves.

17. SBA's burden of rectifying COVID lending fraud has been discussed at great length. Managing SBA's current loan portfolio, fraud aside, is a monumental task. **How do you justify taking on all of these additional, substantial responsibilities and program extensions when multiple parties—including the Office of the Inspector General and Congress—have repeatedly expressed legitimate concern that SBA does not have the bandwidth or resources to do so?**

    SBA supervises more than 1,700 lenders across our lending programs. We are proposing adding three additional SBLCs. The SBA conducted in-depth assessments to ensure it has capacity to support improvements to the loan programs and provide oversight and servicing to SBA's entire portfolio of lenders, including any potential additional SBLCs. The use of modern tools makes loan program management and lender oversight both stronger and less resource-intensive than it was in the past.

With regard to COVID-19 programs, the SBA OIG is responsible for investigating allegations of fraud and other possible criminal violations. OCA fully supports the SBA OIG, the Department of Justice (DOJ), and other law enforcement agencies' fraud investigations and efforts to hold fraudsters accountable.

18. **When it comes to loan purchases if the loan defaults, how can the lenders be sure that SBA will find their credit underwriting adequate?**

    Beginning August 1, 2023, SBA will be determining the eligibility for all 7(a) and 504 loans prior to SBA loan approval to ensure that loans were not made to ineligible businesses or for ineligible purposes.

    a. **Follow-up: What happens if the SBA finds their credit underwriting inadequate?**

       SBA's guaranty purchase centers review the loan based on the required submission of documents in accordance with written Program Requirements. SBA may deny the purchase of a loan or seek recovery on a loan purchased from the secondary market if the lender has not properly followed all program requirements.

19. In the final rules, you state that the SBA will decide the maximum dollar amount where loans can be credit scored but does not specify any dollar amount up to which a loan can be credit scored. **Can you tell us how you will make that decision and what maximum loan size you have in mind?**

    SBA has, in accordance with the FICO Liquid Credit SBSS Score, reviewed the predictability of scores and determined that scores up to and including $500,000 are within the scope and produce an adequate performance prediction at that dollar amount. These details are provided in SOP 50 10.

    a. **Follow-up: Will this be on a lender-by-lender basis?**

       No. The authority to use SBA's business credit score or the lender's acceptable business credit scoring model is across the board for approved lenders for loans of $500,000 or less.

    b. **Follow-up: The concern, of course, is whether SBA will allow credit scoring on large loans. Is it your plan to allow credit scoring up to $5 million?**

       No. SBA will limit the use of credit scores in underwriting to loans of $500,000 or less.

20. Does the Agency recognize that entities can control other entities by virtue of conditions in contracts or management agreements?

SBA recognizes that small businesses have the need and ability to contract for services and products in the conduct of their businesses.

21. Do you believe the SBA is authorized to make a pilot program permanent by telling the participants of the pilot program that they can move to a new permanent program?

No. SBA, through rulemaking is authorized to admit additional non-regulated entities to participate in the permanent program.

a. Follow-up: Does SBA authorize programs?

Congress authorizes our programs, and SBA continues to implement and oversee the 7(a) loan program, the 504 Loan program, and the Microloan program in accordance with statutory requirements. SBA has various delivery methods under which 7(a) loans may be submitted and approved. For example, SBLC is not a program – it is a type of lender participating in the 7(a) program, and SBA Express Loans are 7(a) loans of a certain size delivered only by lenders with that specific authority.

Questions from Rep. Aaron Bean

1. For non-federally regulated entities that apply for SBLC licenses:

a. How does SBA plan to serve as the primary regulator and provide oversight of these lenders?

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

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

- Annual reviews of each CA SBLC and SBLC's audited financial statements (which are prepared by an independent certified public account). The audited financial statements from CA SBLCs must include the CPA's assessment of the lender's compliance with the loan loss reserve requirements; and
- Risk-based reviews of CA SBLCs and SBLCs to ensure that lenders are in compliance with SBA Loan Program Requirements. SBA's Loan and Lender Monitoring System (L/LMS) and Lender Portal enables OCRM to track and analyze SBA Lender performance (such as early problem loans and delinquencies). SBA uses L/LMS to assist in prioritizing, planning, and conducting more in-depth reviews of higher volume lenders and to monitor SBA lenders between more in-depth reviews. In-depth reviews may include Limited Scope Targeted Reviews, Safety and Soundness Exams, or Delegated Authority Reviews.

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

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

Separately, review activities will be used to monitor risk, correct behavior, and ensure compliance with capital adequacy, asset quality, management quality, earnings, liquidity, and compliance with general Loan Program Requirements.

Reviews are conducted at a greater frequency than examinations, require fewer resources, and are less invasive which facilitates timely risk-identification and corrective action while allowing the CA SBLC to remain focused on delivering capital to America's small businesses. During a two-year period, a CA SBLC will be subject to no less than 10 review actions. Review activities are conducted quarterly based on required submissions related to the CA SBLC's financial condition, legal and administrative proceedings, reports of change, and the like.

These review activities are cost-advantageous to CA SBLCs with small dollar 7(a) loan portfolios as the review cost is spread across all 7(a) SBA Supervised Lenders as part of the annual fee schedule for SBA's oversight of 7(a) Lenders.

The CA SBLC will also be subject to at least one risk-based review per year that involves data analysis, an assessment of management and operations, and an inspection of 7(a) loan files. The only time this review activity would not be conducted is if the CA SBLC is subject to an examination that year. The current cost for this risk-based review, on average, is less than $5,000; comparatively, an examination typically costs more than $45,000. In addition, OCRM will internally perform a quarterly analysis of the data to

identify any trends that indicate emerging risk with action taken when appropriate. Typical actions include conducting a risk-based review that has a narrow scope to focus on the identified risk.

2. According to a recent White Paper from the SBA OIG, the inspector general states that, "Oversight staffing levels in the Office of Credit Risk Management decreased from 42 to 26 employees. This staff reduction could affect SBA's FY 2023 goal for oversight reviews, which help ensure lender compliance with program requirements."

    a. **Mr. Kelley, do you believe SBA is equipped to take on this additional responsibility when even the OIG is warning you that these staffing shortages are a risk to the integrity of the 7(a) program?**

    Yes.

3. Much like you Mr. Kelley, I am also a banker. As a banker I'm very familiar with the underwriting process. These new rules change the underwriting standards so lenders can use generally acceptable commercial credit analysis for their similarly sized, non-SBA guaranteed commercial loans.

    a. **How will moving the program towards a more subjective underwriting method protect taxpayers from losses?**

    SBA's responsible management of the business loan programs have kept them near or below zero—meaning SBA lending is not expected to cost the taxpayer money aside from administrative expenses.. SBA will continue to prudently oversee the program to manage as we have done for decades. Notably, the changes in underwriting criteria have been thoroughly tested through the SBA Express loan program, which has outperformed the 7(a) product when it comes to term loans under $350,000 for 20 of the last 23 years.

4. **When it comes to loan purchases if the loan defaults, how can the lenders be sure that SBA will find their credit underwriting adequate?**

Beginning August 1, 2023, SBA will be determining the eligibility for all 7(a) and 504 loans prior to SBA loan approval to ensure that loans were not made to ineligible businesses or for ineligible purposes.

    a. **Follow-up: What happens if the SBA finds their credit underwriting inadequate?**

    SBA's guaranty purchase centers review the loan based on the required submission of documents in accordance with written Program Requirements. SBA

may deny the purchase of a loan or seek recovery on a loan purchased from the secondary market if the lender has not properly followed all program requirements.

5. I have read that the SBA has been investigating four Fintech companies for PPP fraud.

   a. What is the scope of the investigations?

   Lender investigations are primarily the responsibility of the SBA OIG and DOJ and other law enforcement agencies. SBA supports their efforts through OCA and OGC staff. OCRM is conducting targeted risk-based reviews of PPP lenders to determine how well they complied with the BSA/KYC requirements.

   b. Will the SBA investigate the fees charged by these companies to the SBA's PPP lenders?

   SBA is examining these issues.

   c. When does the SBA expect to finalize each of these investigations?

   Because of the on-going investigations by SBA and law enforcement agencies, we cannot provide a timeline for its conclusion at this time.

6. **What actions are being taken by the SBA to prevent private companies from avoiding oversight or compliance with SBA requirements specific to lenders' service providers (LSPs) and agents?**

   The SBA works closely with field office personnel to identify concerns and with the Office of General Counsel to define appropriate actions.

7. I have read that Womply categorized itself as a technological service provider, potentially to avoid rules or guidance that would apply to LSPs and agents, despite performing services that were similar or identical to those traditionally performed by LSPs, as described by SBA. **Will the SBA take any steps to facilitate ongoing, proactive oversight of LSPs and agents based on their performance in the PPP?**

   On December 8, 2022, SBA suspended Oto Analytics, Inc dba Womply from engaging in any actions related to SBA lenders, SBA loans, and/or SBA's loan programs with the exception of forgiveness processing. That suspension has been extended through December 3, 2023 and now covers all actions related to SBA lenders, SBA loans and/or SBA loan programs.

8. The Administrator wrote a letter to the Senate Small Business Committee dated March 20 that said: "Today as a federal regulator of the 7(a) and 504 loan programs, SBA applies safety and soundness measures to all non-bank lenders, including SBLCs, through the PARRiS and SMART risk frameworks. These frameworks were designed during the Obama Administration to follow the FDIC CAMELS rating framework of classifying a lender's overall condition. Part of this framework establishes that all loans are rank order or stress tested on a quarterly basis and assigned portfolio scores for asset quality. All 7(a) lenders, including SBLCs, are required to comply with Bank Secrecy Act/Know your Customer/Anti Money Laundering standards and SBLCs are also responsible for and evaluated on compliance with: Truth in Lending, state by state usury laws, Equal Credit Opportunity, and the Gramm-Leach Bliley Act." Given these statements, please answer the following:

   a. **Where can I go look to find SBA's existing guidance to 7(a) lenders and particularly existing SBLCs on Bank Secrecy Act/Know Your Customer/Anti-Money Laundering?**

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

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

      > *Entities that are not presently subject to the requirements of the BSA, should, prior to engaging in PPP lending activities, including making PPP*

loans to either new or existing customers who are eligible borrowers under the PPP, establish an anti-money laundering (AML) compliance program equivalent to that of a comparable federally regulated institution. Depending upon the comparable federally regulated institution, such a program may include a customer identification program (CIP), which includes identifying and verifying their PPP borrowers' identities (including e.g., date of birth, address, and taxpayer identification number), and, if that PPP borrower is a company, following any applicable beneficial ownership information collection requirements. Alternatively, if available, entities may rely on the CIP of a federally insured depository institution or federally insured credit union with an established CIP as part of its AML program. In either instance, entities should also understand the nature and purpose of their PPP customer relationships to develop customer risk profiles. Such entities will also generally have to identify and report certain suspicious activity to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN).

See, 85 FR 20811, 20815 (April 15, 2020). As all existing SBLCs participated in the PPP program, they were required to comply with these BSA underwriting and reporting requirements.

b. Can you confirm for me right now that SBA requires SBLCs and all 7(a) lenders to specifically comply with BSA/KYC/AML standards, that SBA's examination guidelines outline how SBLCs will be reviewed for BSA/KYC/AML protocol, and that SBA has policies on enforcement and monitoring of these standards?

SBA requires that all lenders comply with applicable BSA/KYC/AML standards. The targeted reviews described in a previous response are currently underway and are incorporated into the OCRM risk-based review and examination process.

OCRM has the authority to take informal or formal enforcement action against lenders who do not comply with these requirements.

c. Can you give the Committee off the top of your head an example as to how SBA incorporates these compliance requirements with BSA/KYC/AML into recent exams over the past Fiscal Year in order to demonstrate how the Agency checks for compliance on a regular basis?

Please see the response to Question 8 part b.

Questions from Rep. Judy Chu

Community Advantage SBLC Lender Requirements

1. Community Advantage lenders have no capitalization requirement in the current CA pilot program, which is important because these lenders are small, often nonprofit lenders with far less cash on hand than larger financial institutions like banks. Regular SBLCs currently have a capital requirement of $5 million, which would be extremely prohibitive if applied to the new CA SBLCs. The May 1st notice from SBA to all Community Advantage Pilot Program Lenders states that "SBA will hold all CA SBLCs to the same requirements that have existed for the CA Pilot Program, as outlined in the Community Advantage Participant Guide." This suggests that CA pilot lenders can expect no new capital requirements upon transitioning to CA SBLCs. However, the final SBLC rule gives the SBA Administrator authority to set a minimum capitalization requirement at their discretion.

   Can you confirm that CA SBLCs will face no capital requirements?

   A non-regulated entity may not participate in the 7(a) program without adequate capital, as determined by the SBA Administrator. Capital is required in order to make loans.

   The SBA Administrator, in consultation with SBA's Associate Administrator for the Office of Capital Access (AA/OCA) or their designee(s), at their discretion, will determine the appropriate minimum capitalization requirement for CA SBLCs. At present, no minimum has been established.

2. Additionally, regular SBLCs face much higher oversight fees than current CA pilot program lenders which would again be cost prohibitive if applied to CA SBLCs. **Can you confirm that CA SBLCs will face the same oversight fees as current CA pilot lenders?**

   SBA is sensitive to the impact of oversight fees on CA SBLC lenders. During a two-year period, a CA SBLC will be subject to no less than 10 review actions. Review activities are conducted quarterly based on required submissions related to the CA SBLC's financial condition, legal and administrative proceedings, reports of change, etc.

   These review activities are cost advantageous to CA SBLC's with small dollar 7(a) loan portfolios as the review cost is spread across all 7(a) SBA Supervised Lenders as part of the annual fee schedule for SBA's oversight of 7(a) Lenders.

   The CA SBLC will also be subject to at least one Risk-Based Review per year that involves data analysis, an assessment of management and operations, and an inspection of 7(a) loan files. The only time this review activity would not be conducted is if the CA SBLC is subject to an Examination that year.

   The cost for this review is currently averaging less than $5,000 whereas an Examination typically costs more than $45,000.

Loan Loss Reserve Requirements for CA SBLCs

3. SBA's May 1st notice to CA lenders clarified the loan loss reserve (LLR) requirements these lenders can expect upon transitioning to CA SBLCs, which were modeled after the Community Advantage Loan Program Permanency Act, legislation I introduced last Congress. These loan loss reserve requirements will ensure that these small, nonprofit lenders who have been making Community Advantage loans for more than 5 years will have greater flexibility and more capital to do even more lending. However, the notice does not fully mirror my bill because it does not address LLR requirements for selling loans on the secondary market.
Will the SBA correct this and apply my bill's LLR requirements for selling loans on the secondary market to the new CA SBLC program?

   We will take your views under consideration.

Seeking Evidence that New Regular SBLCs will Increase Underserved Lending

4. The final SBLC rule lifts the current moratorium on regular SBLCs with the stated goal of better filling persistent gaps in access to capital, particularly for startups, rural, minority-owned, and the smallest small businesses. However, regular SBLCs, unlike Community Advantage SBLCs, do not have any requirements for lending in underserved communities.
What evidence does the SBA have that merely lifting the cap on regular SBLCs will actually increase lending to the underserved?

   Lenders, like all businesses, tend to have an established business model—a method for issuing loans and a target customer group—that works well for their business structure and practices. To reach new borrowers, in particular small dollar borrowers, SBA is both working with existing lenders to expand to new small business customers and adding new lenders, who are already working with the types of small businesses SBA is trying to reach.

   As outlined in the Federal Register Notice on the Small Business Lending Company Application Process, the evaluation process for new SBLCs will include: The lending policies of the proposed SBLC, including those for non-SBA loans, and their alignment with SBA's mission; as well as other relevant information (such as SBA-observed gaps in small business lending not served by the existing 7(a) Lender population, including small-dollar lending and loans to underserved populations).

The Need for Clarity and Certainty for Mission-Based Lenders

5. I want to thank SBA for providing Community Advantage lenders with more certainty by incorporating them into an SBLC model that will allow for permanent participation in the

7(a) program. This is a major step forward, but I want to emphasize the importance of the SBA providing these lenders with as much clarity and detail as possible when your agency announces program changes. **Can you describe how strong communication and collaboration between SBA and the community of SBA lenders, including CA lenders, factors into program uptake and success?**

SBA maintains strong lines of communication with all SBA program participants, including CA Pilot Program Lenders in their transition to CA SBLCs. The Office of Capital Access is working closely with these lenders to facilitate their successful conversion.

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