To: NAPL Members and CDC Colleagues *Date:* April 21, 2010

From: Bruce Thompson, Executive Director of NAPL

Subject: Response to Report on Audit of Premier Certified Lenders in the Section 504 Loan Program Report No. 10-10

To our colleagues:

We feel it is important to take a moment to address the study on Premier Certified Lenders recently released by the Office of Inspector General. When one reads past the sensationalized headlines, the content of the report and SBA's responses conclude that there is little to substantiate the claim that the PCL lenders have abused their authority and jeopardized the 504 loan program. Further, we are genuinely concerned about the recommendations contained in the report and the far reaching impact it will have on most every CDC in the nation. This concern is born out of an understanding that the bulk of the criticism, the "findings" that were repeated, were not items unique to PCL lenders, but rather an indictment of SBA's policies and guidelines.

We applaud SBA for taking a stand against several of the findings – often on the basis that the PCL lenders followed SBA SOPs and thus, in the eyes of SBA, did not make poor underwriting decisions, misinterpret eligibility determinations or miss loan closing requirements, as highlighted in the OIG report. Further, SBA demonstrated its understanding of industry practices/standards by supporting several underwriting procedures which OIG characterized as creating a lending environment fraught with abuse and poor decisions. As noted, the vast majority of the eligibility issues cited dealt with the use of base closures to meet the public policy goals. These goals are open to ANY CDC and certainly do not reflect solely upon PCL lenders. As SBA clearly stated in their response, using a base closure to meet a public policy goal is permissible whether the deal is being approved as a PCL or ALP loan.

Additionally, the lack of comparison to ALP lending practices renders this study less defensible and rather than a condemnation of PCL lending practices, became a critique of SBA policies and guidelines and SBA's interpretation of the policies. We are concerned that SBA may be forced into implementing the recommendations made by the OIG report – in which case the program volume would likely decline dramatically – as all CDCs would face a large number of small businesses that would no longer qualify for the 504 loan program. Please consider the consequence of the following OIG recommendations:

1- Use of Actual cash flow analysis vs "rule of thumb cash flow analysis" (accrual). As SBA stated, it remains their policy to allow CDC's to utilize either cash flow analysis. A large majority of SBA 504 (both ALP and PCL) loans are approved using the "rule of thumb" method. Our bank lending partners use the "rule of

thumb" method because it more accurately measures a company's ability to repay a long term loan. The actual cash flow method is more suited for short term financing such as lines of credit and thus is a more conservative way to underwrite transactions. Use of this method for SBA 504 loans will lead to a significant decline in a CDC's ability to get loans approved by SBA. Additionally, the information required by the actual cash flow method is difficult to obtain in some cases, as many small businesses do not maintain that level of sophisticated accounting on an ongoing basis. Finally, the SBA form 1244 provides the methodology for cash flow analysis; if OIG wants CDCs to utilize a different methodology, SBA will need to revise the Form 1244.

2- Limiting the use of Officer's Salary to historical levels. Again, SBA had the correct response. Our borrowers know that trade-offs must often be made in order to purchase a building. CDC's, similar to our bank lending partners, need the flexibility in underwriting to analyze the officer's salary in order to properly make a credit decision.

3- Use of historical sales to support projections. Implementation of this recommendation would reduce access to the 504 program for many borrowers. Rapidly growing companies, companies whose sales growth is predicated upon expansion, or those expanding their product line, will not be able to get the financing they need to purchase a building to meet their expansion needs. This would eliminate one of the goals of the 504 program, to provide fixed asset financing to growing small businesses.

Again – singling out PCLs for using base closure as a public policy goal, or an SBA acceptable cash flow method is inappropriate, as many CDCs rely on these very same SBA- approved policies. Tightening the interpretation of such policies will minimize the program availability to borrowers across the nation regardless of whether the CDC is approving the loan as a PCL or ALP loan.

We believe most CDCs will come to a similar conclusion that the items pointed out in OIG's study are practices utilized by most all CDCs under SBA's approval – as noted in SBA's response to the OIG study. Further, at a time when the Administration is focused on getting additional capital to small businesses – this report seems to run contrary to our mission to support small businesses. It is our hope that SBA remains steadfast in their commitment to the existing SBA policies in defense of the CDC industry and lender partners as we advocate for the small business community.

Furthermore, we have heard some concerns about escalating PCL default rates/losses. As we view the SBA documentation we find that indeed the rates have risen on PCL loans, but only to a level similar to the other loans in the entire 504 portfolio. As recently noted by SBA officials- the overall 504 loan portfolio is at a 4.71% delinquency rate while the PCL portfolio has a 4.94% delinquency rate. Further the repurchase rate for the entire 504 loan portfolio is 4.10% while the repurchase rate for the PCL portfolio is 3.98%. The

difference is statistically insignificant. Further the rates confirm that whether a loan is completed using PCL or any other status bears no impact on the performance of the loan. PCLs are clearly not creating unnecessarily high losses and future higher subsidy rates for our borrowers due to any "dubious business practices". Since PCLP loans currently represent approximately 17% of the existing 504 portfolio, one could conclude that the losses from the PCLP portfolio represent less than 20% of the increase in the subsidy rate. As both the OIG report and SBA reported – 84% of the 25 loans reviewed were performing.

In addition, it is in a PCL CDC's best interest to conduct diligent underwriting and eligibility reviews, as a PCL CDC faces financial risk, along with the SBA, in the event a loan goes into default. There is no incentive or advantage for a PCL to engage in risky underwriting practices. A delinquency or loss on a PCL loan is a potential loss to the CDC directly.

Lastly, we were confounded to see the OIG include comments on "executive compensation" in this report. The comments on executive compensation were not compiled with any transparency. There were no comments regarding the methodology of collecting data, short of the year of the 990s. No comments were shared on how it was determined who would be considered "executive management" and clearly no effort to confirm that the findings in the 990 reports were uniform from one CDC to the next. There were also no details on any specifics taken into account in the comparison of CDCs, short of the fact that all experienced gross receipts over $1 million. This leaves a very wide berth for further interpretation. Finally, it is clear the OIG did not research any of the third-party compensation reports that have been completed for some of these CDCs over several years. The suggestion that such compensation study, although unclear on the impact, is remotely tied to PCL loan performance is disconcerting and unsubstantiated.

We will continue to provide quality services to our borrowers and lending partners to ensure the 504 loan program remains viable. Additionally, we will continue to support SBA's efforts to maximize the reach of the 504 loan program to America's small businesses through the implementation of industry accepted policies and practices.