Ms. Dianna Seaborn  
Director  
Office of Financial Assistance  
U.S. Small Business Administration  
409 3rd Street, S.W.  
Washington DC 20416

Re: Proposed Rule on Affiliation and Lending Criteria for the SBA Business Loan Programs  
87 FR 64724 [“Affiliation Proposed Rule”]

Dear Ms. Seaborn:

The National Association of Government Guaranteed Lenders (NAGGL) appreciates the opportunity to provide comments regarding the above-referenced Affiliation Proposed Rule and request for comments.

NAGGL continues to strongly support the stated purposes of the proposed changes – “to expand access to capital for small businesses and drive economic recovery”. However, we do not believe that all the regulatory amendments being proposed would serve to achieve these laudable objectives.

In this regard, we believe that it is important to examine this regulatory proposal as part of an overall strategy of the Agency that also includes a second Proposed Rule, Small Business Lending Company (SBLC) Moratorium Rescission and Removal of the Requirement of a Loan Authorization (87 FR 66963) [“SBLC Proposed Regulation”]. In addition, to give interested parties a full understanding of how SBA intends to revamp its loan programs, we believe that it would be helpful to know what additional changes SBA intends to make in the revision to the standard operating procedures manual (SOP) governing lender participation and loan program requirements for the 7(a) and 504 Programs, SOP 50 10, Lender and Development Company Loan Programs. SBA had announced that revision would be issued in November, with a mid-January effective date, but has not yet released the revised SOP. SBA also had indicated that the SOP revision would contain major changes to program requirements not constrained by current regulatory language. Knowing the changes that will be included in this document is important because the SOP is not subject to the requirements imposed on the promulgation of regulations, so there will be no opportunity for public comment before the revised SOP takes effect.
But even without having the opportunity to review the revised SOP, based on the regulatory proposals, including the background information in the Proposed Rules, it appears clear that SBA intends to soften or completely eliminate many of its long-standing loan program requirements at the same time that it is proposing to lift its self-established moratorium that, for the past 40 years, prohibited SBA from licensing additional non-federally regulated lenders as Small Business Lending Companies (SBLCs). Per SBA, that moratorium was put into place because the Agency recognized that it lacked the ability to appropriately oversee additional SBLCs.

The confluence of these actions raises far greater concerns than if they were being taken on an individual basis because if all of the regulatory amendments are adopted as proposed, the result will be allowing new non-federally regulated lenders, with no experience in 7(a) lending, to make loans in a program where many of the guardrails that were put into place because of identified risks and that have ensured prudent lending throughout the program’s history, are being lifted. This is especially problematic because, as proposed, SBA could immediately invite additional non-federally regulated entities to participate as 7(a) lenders even before it has time to judge whether removal of the historic program guardrails will have an adverse impact on program performance.

NAGGL supports streamlining and simplifying 7(a) Program criteria where appropriate to increase small business access to capital, especially those small businesses in underserved markets. We believe, however, that the benefits of taking such actions must be balanced against the risks that they could bring to 7(a) portfolio performance. In the case of this regulatory proposal, we believe that several of the proposed amendments do not appropriately balance the rewards and risks inherent in the proposed changes. This raises serious concerns that, on a long-term basis, loan performance could deteriorate causing the program subsidy rates to go up, resulting in higher fees to borrowers and lenders, or the need for Congress to provide appropriations to support the costs of the loan programs. Given the current Federal budgetary constraints, it is unlikely that the Congress would find that such appropriations were appropriate given that the need for them would have been caused by SBA’s own actions that resulted in increased risk and increased losses on SBA-guaranteed loans.

The attachment provides NAGGL’s section-by-section comments relating to the portions of the Affiliation Proposed Rule that would impact the 7(a) Program. Because of the intertwined nature of the two rules, there are some references of the SBLC Proposed Rule in these comments. But we will be providing a separate comment submission specifically relating to the that regulatory proposal.

However, because of concerns relating to both regulatory proposals, by this letter we are restating our strong support of the request made to Administrator Guzman by a group of national trade associations, including NAGGL, that represent virtually all of this country’s 7(a) lenders that SBA temporarily withdraw both Proposed Rules. We believe that this action is essential in order for SBA to chart a more
reasonable course to accomplish the agency goals while avoiding some of the potentially serious consequences that may result if the proposed changes are made final.

Again, thank you for providing this opportunity for us to comment on this critical regulatory proposal.

Sincerely,

[Signature]

Anthony Wilkinson
President & Chief Executive Officer

cc:  Isabella Casillas Guzman, Administrator
     Patrick Kelley, Associate Administrator, Office of Capital Access
     Susan Streich, Director, Office of Credit Risk Management
     Hannibal “Mike” Ware
Proposed Rule on Affiliation and Lending Criteria for the SBA Business Loan Programs

[87 FR 64724]

NAGGL Section-by-Section Comments and Recommendations

Regulations proposed to be amended – 13 CFR 120, Business Loan Programs, and 13 CFR 121, Small Business Size Regulations.

13 CFR 120, Business Loan Programs

13 CFR 120.130, Restrictions on uses of proceeds and 13 CFR 120.202, Restrictions on loans for changes of ownership

SBA is proposing to revise the regulations to remove language that currently prohibits the use of 7(a) loan proceeds to fund the purchase of a portion of a business or another owner’s interest in a business. In addition, although not addressed in the regulatory language, according to the Agency’s section-by-section analysis, the regulatory proposal would permit a seller involved in such a transaction to permanently remain as a part owner and employee of the borrower business, something that now is generally prohibited.

NAGGL opposes this proposed change for several reasons. Most importantly, it appears that this regulatory proposal could create a conflict with language in 13 CFR 120.130, Restrictions on uses of proceeds, paragraph (a). That provision prohibits the use of 7(a) loan proceeds for, among other purposes, “[p]ayments, distributions or loans to Associates of the applicant (except for ordinary compensation for services rendered ...” Per current 13 CFR 120.10 which is not proposed to be changed in either of the Proposed Rules, an associate of a loan applicant includes, among others: “An officer, director, owner of more than 20 percent of the equity, or key employee of the small business ...” Therefore, allowing 7(a) loan proceeds to be used for a partial change of ownership that would allow an existing business owner to sell a portion of their ownership interest while continuing as an owner and employee could result in a prohibited use of 7(a) proceeds in those cases where the seller remaining in the business would continue to meet any of the criteria defining an associate of a loan applicant.

SBA could resolve this issue by amending 13 CFR 120.130(a) to provide an exception for partial change of ownership situations. However, NAGGL believes that the cited regulation should not be further amended. In this regard, we believe that the principle underlying the current prohibition against distributing proceeds of a 7(a) loan to an associate of the applicant business protects against sham transactions where an individual personally receives 7(a) loan proceeds while continuing to play a key role in, or retaining control over, the operations of the business. We also believe that the proposed change would effectively result in the creation of personal, rather than business, loans without appropriate benefit to the entities that will be obligated to repay the debts.
Therefore, for the reasons noted, we oppose the proposed changes and support the continuation of existing SBA regulations and policy that prohibit a new individual or entity [excluding an Employee Stock Ownership Plan (ESOP)] from buying only a partial interest in the business, especially when the existing owner who would be selling only part of their interest in the business would be allowed to permanently remain as an associate of the business.

13 CFR 120.150, What are SBA’s Lending Criteria?

SBA continues to require that loan applicants (including any operating companies) be creditworthy and that loans must be so sound as to reasonably assure repayment ability. But the proposed regulatory amendment would remove the detailed list of factors to be considered when determining whether a loan applicant is creditworthy, including removing the requirement that character and reputation be considered. As a substitute for the existing factors, SBA is proposing to amend the regulations to require lenders and CDCs to use “appropriate and prudent generally acceptable commercial credit analysis processes and procedures consistent with those used for their similarly-sized, non-SBA guaranteed commercial loans”. Under the new regulatory language, SBA, Lenders and CDCs would be allowed to consider, as applicable, three specific criteria when approving loans: 1) the credit score or credit history of the applicant (and any operating company), its associates and guarantors; 2) the earnings or cashflow of the applicant; or, 3) where applicable, any equity or collateral of the applicant.

While not referenced in the regulation, in the background discussion, SBA acknowledges that there is a category of 7(a) lenders, including many of the non-federally regulated lenders, that do not make conventional loans, so do not have such criteria to fall back on. And, here it is important to note that, if the SBLC Proposed Rule is adopted, that group could be greatly expanded since the proposed regulatory language does not set a maximum number of new regular or Mission-Based SBLCs that SBA can approve as 7(a) lenders. While the proposed regulatory language is silent regarding how such circumstances are to be handled, the background information indicates that SBA’s intention is to allow lenders without conventional loan portfolios to underwrite their 7(a) loans in accordance with the credit policies, including credit scoring models, approved by SBA as part of their initial approval for SBA participation and/or during lender oversight processes. This would mean that lending criteria for lenders that do not make similar conventional loans would be established on an entity-by-entity basis without the consistent underwriting framework that currently exists.

NAGGL believes that the existing regulations provide an appropriate broad underwriting framework that should continue to apply to all 7(a) loans. Therefore, for several reasons, we object to the virtually complete removal of the general credit underwriting requirements and to allowing lenders to decide individual loan applications based completely on their own credit policies and practices.

First, we believe that the result of this change would be a lack of consistency in loan processing that would allow a small business’ loan application to be evaluated under different criteria, and possibly even
decided differently, based on the lender to which the small business submits its application. Clearly, this would not be a benefit to small business borrowers, especially those in underserved markets.

Most importantly, on a long-term basis, since SBA would no longer be providing minimum standardized underwriting requirements, we believe the result could be a deterioration of 7(a) credit quality, including the possibility that lenders that have more rigorous requirements would be forced to compete with those that have less rigorous requirements. This could be particularly concerning for those lenders that are not federally regulated so are not subject to the underwriting requirements imposed by the Federal Regulators. And here it is important to remember that, as noted in our cover letter, the existing prudent underwriting standards were put into place in program regulations and SOP over many years in direct response to imprudent lender behavior identified by SBA. So, while we support appropriately simplifying and streamlining the program, we cannot support such changes when any potential benefits would be outweighed by increased risks to the program. And, in this case, we believe that the proposed changes could have a long-term detrimental impact on portfolio performance and on the integrity of the 7(a) program.

As also noted in our cover letter, a major concern is that these changes could cause the program subsidy rate to go up thus adversely impacting borrower and lender fees, and possibility creating the need for the Congress to provide appropriations to cover the increased costs of 7(a) loans.

However, if SBA decides to eliminate its current regulatory list of consistent underwriting considerations, we believe that it would be appropriate to require all non-federally regulated lenders (NFRLs), including SBLCs, to comply with the same general underwriting requirements that are imposed by the Federal regulators on the institutions that they regulate. Such criteria is included, for example, in Section 3.2 of the Federal Deposit Insurance Corporation (FDIC) Risk Management Manual of Examination Policies which describes the review process for “evaluating lending policies and credit administration practices, as well as their effectiveness to maintain loan quality and mitigate loss”.

We also object to removing from the regulations the standardize list of underwriting considerations because, in the case of those lenders without conventional loan policies, approval of lending criteria on a case-by-case basis would add a significant new burden to SBA staff including those in SBA’s Office of Credit Risk Management (OCRM) who will have oversight responsibility for all the new SBLCs in addition to those current program participants that they already oversee. Any additional burden to OCRM raises concern regarding how an office already seemingly at capacity given its scope of responsibility and limited resources could take on a greater role and maintain appropriate, diligent oversight of a growing portfolio simultaneously. However, if SBA decides to proceed with this change as proposed, we recommend that it add language to the regulation specifying the minimum standards that SBA would impose for the development of credit underwriting policies and practices by those lenders that do not make similarly sized conventional loans. This could include, for example, the requirement for the lender to address the factors that it would consider in deciding creditworthiness. Providing such broad
parameters would help to assure, at least to some degree, consistency between the policies established by individual SBA regulated lenders.

We also believe that as part of its consideration of this change, SBA should provide information regarding how, when a loan that was underwritten under the lender’s individual underwriting criteria defaults and SBA is requested to honor its guaranty, the Agency will determine that the lender made, closed, serviced and liquidated the loan in a prudent manner, one of the standards currently in place for loan purchases. [13 CFR 120.524] SBA also is proposing to add language to the regulations that would permit lenders, CDCs and SBA to use a business credit scoring model which, according to the background information, could be either the SBA credit scoring model [FICO® Small Business Score (SBSS)] or the lender’s own validated scoring model. This proposed change is consistent with the recent, and still largely untested, change made in the Community Advantage (CA) Pilot Program which has a public policy purpose and a maximum loan size of $350,000; and with long-standing policy in SBA Express which has a reduced 50 percent guaranty and a maximum loan size of $500,000. But NAGGL does not believe that it is appropriate for the general 7(a) loan program where the loan size may be as high as $5 million and the SBA guaranty may be as high as 85 percent. Therefore, for the reasons noted in the discussion below, NAGGL opposes allowing lenders to use their own credit scoring models for 7(a) loans of all sizes.

The Proposed Rule is silent as to whether it is SBA’s intent to expand the use of the SBSS for loans over the current $350,000 maximum size for which that model was developed and currently may be used. So, we would ask the agency to clarify its intent on this point. And, if SBA intends to allow the SBSS model to be used for loans over $350,000, we request that it provide information regarding whether it will be adjusted for larger sized loans and how SBA will satisfy any lender concerns about its ability to accurately predict performance above its original loan size limit. But absent information regarding what SBA intends, NAGGL’s current opinion is that the existing SBA SBSS model should continue to be the only scoring model used for all 7(a) Small Loans. This scoring model was developed a number of years ago by SBA working with Dun and Bradstreet, and, since then, has been used as the sole scoring model for determining creditworthiness for 7(a) Small Loans, and, until recently, for CA loans. The model has been validated and tested based on SBA loan performance, and the Agency has indicated its strong confidence in it as a tool for determining creditworthiness for 7(a) small loans.

To allow lenders to use different scoring models, particularly for Standard 7(a) loans (i.e., those over $350,000), would result in a lack of consistency from lender-to-lender and from applicant-to-applicant. This also would add to the burden placed on SBA staff charged with approving new regular 7(a) lenders and monitoring lenders’ participating in the program since the efficacy of each proposed model would have to be evaluated separately by SBA. Therefore, before adopting this change for Standard 7(a) loans, NAGGL would urge SBA to develop criteria to effectively measure, in a standardized way, the ability of the individual credit scoring model to accurately predict the performance based on the nature and size of the loans for which the scoring model will be used.
NAGGL notes that SBA’s rationale for authorizing lenders to use credit scoring is that it would “increase the number of small loans approved while generally decreasing the length of time required to process a loan”. [Emphasis added.] SBA further states that “[n]ot all lenders will use credit scoring, and those that do will limit credit scoring to small loans”. NAGGL disagrees with this statement because, by separate Proposed Rule, SBA is proposing to open the SBLC program to additional non-federally regulated lenders, presumably including FinTechs which typically evaluate loan applications based on artificial intelligence algorithms. Therefore, if SBA decides to allow lenders to use their own credit scoring models, and if SBA actually intends that credit scoring be used only for small loans as that term is defined by SBA, NAGGL believes that it would be essential for the regulation to specify the maximum size for which a lender may rely on a credit score to demonstrate the requisite creditworthiness and repayment ability.

Finally, we question SBA’s conclusion in its benefits and cost analysis that revising the lending criteria, including permitting lenders to use their own credit scoring models, “will not compromise the credit quality of the overall 7(a) and 504 portfolios”. In this regard, we do not believe that, as discussed more fully above, it is a given that there will be no deterioration of credit quality when long-standing program guardrails would be removed. This concern is exacerbated given that, simultaneous with this change, SBA is proposing to allow additional non-federally regulated entities would be allowed to participate as 7(a) lenders.

13 CFR 120.160(c), Loan conditions

SBA is proposing to amend existing regulations to require hazard insurance only for loans greater than $150,000, and per the supplementary information, intends to establish in non-regulatory program guidance requirements that, for loans of $150,000 or under, would allow lenders to follow the procedures they have established and implemented for their similarly-sized, non-SBA-guaranteed commercial loans.

NAGGL agrees that any personal property collateral securing a 7(a) loan of $150,000 and under likely would have minimal recoverable value. Therefore, we support this change as it relates to the requirement for insurance on personal property collateral.

However, since real property collateral is the collateral that is most likely to provide recovery to the lender/SBA in the event of a loan default, and since uninsured damage to, or destruction of, such collateral when it houses the business operations likely would result in the failure of the business, we believe that SBA should continue to require that the lender/SBA interests in such collateral be protected by requiring hazard insurance. Therefore, we strongly recommend that SBA revise the Proposed Rule to require hazard insurance on any real estate collateral taken to secure a 7(a) loan, regardless of loan amount.
In addition, since most regular 7(a) lenders are federally regulated, we recommend that SBA consult with the federal Regulators regarding whether they find it appropriate for lenders to require hazard insurance on collateral taken to secure small business loans, and to consider making SBA’s requirements consistent with those of the federal regulators for all SBA 7(a) lenders, even those that are not federally regulated. This would ensure consistent insurance requirements from lender-to-lender and loan to loan, again leveling the playing field for all lenders and all borrowers.

13 CFR 120.193, Reconsideration after denial

Current regulations require that a final decision on the reconsideration of a denied loan request be made by the Director, Office of Financial Assistance. SBA is proposing to amend current regulations to allow such decisions to be made either by the Director or by the Director’s designee(s). According to the background information, while the section being revised appears under the heading “Loan Applications”, SBA also intends that the revision apply to requests for loan modifications, presumably including post-disbursement loan modifications.

NAGGL does not object to this change. But, since there is no similar regulatory language in the regulations relating to loan servicing, we recommend that SBA further revise the regulation to specifically mention that the reconsideration authority extends to post-disbursement requests for loan modifications, e.g., by amending the language to read: “If the reconsideration of a loan application or loan modification is denied ...”.

SBA also is proposing to provide an SBA Administrator discretion to intervene to review a reconsideration request and make the final Agency decision.

NAGGL opposes this proposed change because we believe that having career staff make final decisions regarding individual loans based on historical precedent as applied to the circumstances of the individual situation assures consistency in the approval process. Changing this long-standing policy could create an appearance of politicization of the SBA loan approval process and could result in a lack of consistency in how such decisions are made for individual applicants/borrowers and also could allow the inconsistent application of the same program requirements by different Administrations.

13 CFR 121, Small Business Size Regulations

13 CFR 121.301, What size standards and affiliation principals are applicable to financial assistance programs

SBA is proposing to eliminate three of the five current affiliation criteria – affiliation based on management, affiliation based on identity of interests between close relatives and affiliation based on license/franchise agreements. It is further proposing to make major changes to the criteria for finding affiliation based on ownership, including removing the principle of control of one entity over another when determining affiliation.
NAGGL agrees that making some changes to the affiliation standards could simplify the loan approval process. But, noting that small business operational structures have become more complex over time, we have serious concerns about whether eliminating all forms of potential affiliation other than ownership may result in larger, more complex, and more sophisticated business structures qualifying for multiple SBA-guaranteed loans – something that we do not believe is in keeping with the intent of the Small Business Act. And here we think that it is important to distinguish between the Paycheck Protection Program (PPP) and the regular 7(a) program. PPP was intended as a grant program, provided in the form of a loan, to help businesses survive during an unprecedented pandemic by providing funds to meet payroll and for other limited business expenses, whereas regular SBA loans are intended to start and grow small businesses, not to rescue them during an economic catastrophe. Therefore, we do not believe that it is appropriate to cite the PPP legislation as a rationale for eliminating most existing affiliation standards for the regular SBA-guaranteed loans.

While NAGGL has some concerns regarding increasing the ownership thresholds at which affiliation will be found, it does not oppose this proposed change. But we do not concur with removing control as part of the consideration of whether two entities are affiliated. We believe that the existing regulatory requirements relating to control should continue to be included in the affiliation regulations because both common ownership and common control are essential factors in determining whether a small business actually operates on an independent basis.

NAGGL concurs with the proposed change that would eliminate identity of interests as an affiliation criterion.

NAGGL opposes eliminating common management as a basis for determining affiliation. According to the background information regarding this proposed change, SBA’s rationale is that it should not “interfere in a business owner’s right to enter into a service agreement with a management company”. NAGGL disagrees with this position because we believe that if SBA borrowers are allowed to be wholly operated by management companies, the result would be that the business owners would essentially only be investors in the financed businesses, rather than entrepreneurs who devote themselves to achieving success for their small businesses. We believe that this would be a violation of the historical spirit of the Small Business Act.

NAGGL also opposes elimination of the terms and conditions of franchise and license agreements as a basis for finding affiliation. As we indicated in our comment letter relating to the Federal Register Notice on the CA Pilot Program (87 FR 25398, published April 29, 2022 and effective May 31, 2022), we are particularly concerned that SBA would no longer examine the Franchise Disclosure Documents (FDDs) and Franchise Agreements to determine whether they include provisions that could give excessive control over the franchisee’s operations to the franchisor, thus creating a situation where the benefits of the SBA-guaranteed loan actually would accrue to the franchisor. Decades of program history have shown that, but for SBA’s loan eligibility limitations, some franchisors could be inclined to structure their franchisee relationships in a way that benefits the franchisor to the detriment of the independence of operations by the franchisee. We believe that the current franchise processes have proven to be efficient at identifying the limited circumstances where excessive control is present, thus reasonably protecting the interests of the small business borrowers being supported by SBA, a role
assigned to SBA in the Small Business Act. We also note that changing this process would appear to be in direct conflict with the interests of some of those in the Congress who would like to see SBA take a greater role in protecting small businesses in the limited situations where they may be put at greater risk by entering into Franchise Agreements.

NAGGL also opposes eliminating the SBA Franchise Directory, as that action is described in the supplementary information. Feedback from lenders indicates that the current process for determining franchise eligibility is working well, and there is a general question why any revisions are being made to existing program requirements. In fact, there is concern that if the current well-understood franchise process is eliminated, some lenders may be reluctant to attempt to return to the role of having to determine whether a franchise system meets SBA’s loan eligibility requirements, especially because they would not know how SBA might consider the eligibility issues if asked to honor its guaranty. This may cause lenders to shy away from making loans to franchises. Equally concerning is that, if the proposed system is adopted, franchisors would have to address concerns raised by lenders on a loan-by-loan basis, as opposed to being able to resolve eligibility issues directly with SBA on a one-time basis. These issues, among others as described in this section, cause us to worry that some borrowers seeking financing for businesses that operate under franchise or other similar agreements could be unable to find the financing necessary to start or grow their businesses.

According to the background information, SBA would continue to collect a franchisor identifier number (currently called Franchise Identifier Code) on each loan based on a list of such numbers made available through E-Tran, or, when the franchise is not included in E-Tran, would require the lender to request a franchisor identifier number from SBA which would be provided without regard to whether the franchise model otherwise meets SBA eligibility requirements.

In addition, while SBA would continue to require that a franchise applicant meets all Loan Program Requirements, including, but not limited to, those relating to eligibility and lien priority, and acknowledges that this determination may require a “limited examination” of the franchise, or similar, agreement, SBA would no longer make or assist lenders to make those determinations. Instead, it would transfer the burden to lenders who would be required to determine whether a particular franchise agreement creates eligibility issues. And while lenders regularly assess the operations of a loan applicant for compliance with SBA Program Requirements, this determination is different when there is a franchise (or similar) agreement because such agreements would be used on a much broader basis with all franchisees operating under a particular brand being subject to the same requirements. So, in the case of franchise applicants, the result would be that there would be no consistency from lender-to-lender or loan-to-loan regarding determinations of whether basic eligibility criteria are met.

Therefore, if SBA decides to remove franchise and license agreements as a basis for finding affiliation, thus allowing all franchise businesses to be eligible, NAGGL still recommends that SBA continue to review franchise agreements to identify potential issues of loan ineligibility and continue to use the Franchise Directory as the tool for sharing with lender franchise identifier numbers and any brand-specific eligibility issues.