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STATEMENT OF
LOWELL DODGE
ASSOCIATE DIRECTOR
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ON

THE SMALL BUSINESS ADMINISTRATION'S
ECONOMIC OPPORTUNITY LOAN PROGRAM

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

WE WELCOME YOUR INVITATION TO DISCUSS OUR REPORT ON THE SMALL BUSINESS ADMINISTRATION'S (SBA'S) ECONOMIC OPPORTUNITY LOAN PROGRAM. OUR REVIEW WAS REQUIRED BY PUBLIC LAW 95-507. THE COMPTROLLER GENERAL'S REPORT WAS RELEASED TO THE CONGRESS ON DECEMBER 8, 1980, (CED-81-3).

OUR REVIEW SHOWED THAT THE ECONOMIC OPPORTUNITY LOAN PROGRAM HAD BEEN A MEANS TO SUSTAINED ECONOMIC PROGRESS FOR RELATIVELY FEW BORROWERS. WE CONCLUDED THAT PROGRAM RESULTS WERE UNSATISFACTORY AND THAT ATTEMPTS NEED TO BE MADE TO IMPROVE THEM. OUR REPORT INVITES THE CONGRESS TO MONITOR SBA'S IMPLEMENTATION OF OUR SPECIFIC RECOMMENDATIONS, DESCRIBED BELOW. FINALLY, THE REPORT RECOMMENDS THAT UNLESS PROGRAM RESULTS IMPROVE, CONGRESS SHOULD CONSIDER REDIRECTING FUNDS FOR THE ECONOMIC OPPORTUNITY LOAN PROGRAM TO OTHER FEDERAL PROGRAMS FOR DISADVANTAGED BUSINESS OWNERS.



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RECENT LEGISLATION HAS AFFECTED THE ECONOMIC OPPORTUNITY LOAN PROGRAM. THE OMNIBUS BUDGET RECONCILIATION ACT OF 1981 CONSOLIDATED VARIOUS SBA LOAN PROGRAMS, INCLUDING THE ECONOMIC OPPORTUNITY LOAN PROGRAM, INTO A SINGLE BUSINESS LOAN PROGRAM UNDER SECTION 7(a) OF THE SMALL BUSINESS ACT. ALTHOUGH THE ECONOMIC OPPORTUNITY LOAN PROGRAM IS NO LONGER DISTINCT FROM THE PRIMARY SECTION 7(a) LOAN PROGRAM, BUSINESSES THAT HAD BEEN ELIGIBLE FOR ECONOMIC OPPORTUNITY LOANS WILL CONTINUE TO BE ELIGIBLE FOR BUSINESS LOANS UNDER NEW SECTION 7(a)(11). SBA HAS NOT YET ESTABLISHED NEW REGULATIONS AND PROCEDURES TO IMPLEMENT THE STATUTORY CHANGE. TO THE EXTENT THAT SECTION 7(a)(11) LENDING CONTINUES TO REFLECT THE DEFICIENCIES CITED IN OUR REPORT, THE CONCLUSIONS AND RECOMMENDATIONS OF OUR REPORT WILL REMAIN APPLICABLE.

ORIGIN AND MISSION OF THE PROGRAM

THE PROGRAM ORIGINATED WITH THE ECONOMIC OPPORTUNITY ACT OF 1964, AS PART OF THE "WAR ON POVERTY." AT THE TIME OF OUR REVIEW IT WAS ONE OF SEVERAL SBA PROGRAMS TO HELP SOCIALLY OR ECONOMICALLY DISADVANTAGED PEOPLE CREATE AND DEVELOP SMALL BUSINESSES. THROUGH FISCAL YEAR 1980, SBA APPROVED OVER 65,000 ECONOMIC OPPORTUNITY LOANS FOR OVER \$1.1 BILLION. THIS TOTAL INCLUDES \$722 MILLION IN DIRECT LOANS AND \$402 MILLION IN LOAN GUARANTEES.

THE PROGRAM WAS ESTABLISHED WITH A DIFFICULT MISSION. IT FUNDED BUSINESSES THAT COULD NOT GET ASSISTANCE FROM OTHER SBA PROGRAMS OR FROM THE PRIVATE SECTOR. TO BE ELIGIBLE FOR A DIRECT LOAN, A BUSINESS MUST HAVE BEEN REJECTED FOR FINANCING

BY TWO BANKS AND BEEN FOUND UNQUALIFIED FOR SBA'S PRINCIPAL BUSINESS LOAN PROGRAM, THE 7(a) PROGRAM. BORROWERS THAT WE SAMPLED WERE USUALLY JUST STARTING OUT IN BUSINESS AND OWNED MOSTLY VERY SMALL RETAIL OR SERVICE BUSINESSES WITH LOW SALES AND FEW OR NO EMPLOYEES.

RELATIVELY FEW BORROWERS
ESTABLISHED ONGOING BUSINESSES

OUR REVIEW INCLUDED AN EXAMINATION OF BORROWERS WHO RECEIVED LOANS THROUGH FISCAL YEAR 1978 AND WHO WERE NO LONGER CARRIED IN SBA'S PORTFOLIO OF OUTSTANDING LOANS, TO SEE HOW MANY HAD ESTABLISHED ONGOING BUSINESSES. THESE BORROWERS REPRESENT 70% OF THE LOANS DISBURSED THROUGH FISCAL YEAR 1978. MORE THAN HALF OF THIS GROUP WERE BORROWERS WHO HAD DEFAULTED ON THEIR LOANS AND LOST THEIR BUSINESSES. SLIGHTLY LESS THAN HALF ARE RECORDED AS "PAID-IN-FULL."

TO LOOK MORE CLOSELY AT THOSE RECORDED AS PAID-IN-FULL, WE TOOK A STATISTICAL SAMPLE OF BORROWERS RECORDED AS PAID-IN-FULL DURING FISCAL YEARS 1969 THROUGH 1978 AT FOUR MAJOR SBA DISTRICT OFFICES: NEW YORK, CHICAGO, LOS ANGELES, AND MIAMI. BASED ON OUR INVESTIGATION OF THIS SAMPLE, WE ESTIMATED THAT FOR THESE FOUR LOCATIONS ONLY 36% OF THE BORROWERS LISTED AS PAID-IN-FULL HAD ESTABLISHED ONGOING BUSINESSES, OR STATED ALTERNATIVELY, NEARLY TWO-THIRDS HAD NOT. BRINGING INTO OUR CALCULATIONS THOSE WHO HAD DEFAULTED ON THEIR LOANS, WE ESTIMATED THAT ONLY 15% OF ALL OF THE BORROWERS NO LONGER IN THE PORTFOLIO HAD SUCCEEDED IN ESTABLISHING ONGOING BUSINESSES. TRANSLATED INTO NUMBERS OF BORROWERS FOR THESE FOUR OFFICES,

WHICH ACCOUNTED FOR ABOUT 18% OF SBA'S NATIONWIDE TOTAL OF PAID-IN-FULL BORROWERS, WE FOUND THE FOLLOWING:

LOANS NO LONGER IN THE PORTFOLIO	6,882
DEFAULTED LOANS	4,103
LOANS RECORDED AS PAID-IN-FULL	2,779
ESTIMATE OF PAID-IN-FULL BORROWERS WITH ONGOING BUSINESSES	1,010

WE ALSO CHECKED TO SEE HOW MANY OF THE 104 BUSINESSES IN OUR SAMPLE OF PAID-IN-FULL BORROWERS WHO HAD ONGOING BUSINESSES HAD GROWN INTO SIGNIFICANT SOURCES OF EMPLOYMENT. SEVENTY-NINE OF THESE BORROWERS WHO WERE STILL IN BUSINESS GAVE US INFORMATION. OF THESE, 2 HAD DEVELOPED INTO SUBSTANTIAL ENTERPRISES EMPLOYING A TOTAL OF 160 PEOPLE. THE OTHERS WERE STILL MOSTLY VERY SMALL. SIXTY PERCENT STILL HAD TWO OR FEWER EMPLOYEES.

MOREOVER, THE OUTLOOK FOR MANY BORROWERS STILL IN SBA'S PORTFOLIO IS NOT GOOD. AS OF AUGUST 1981, THE PROPORTION OF PORTFOLIO LOANS WHICH WERE DELINQUENT OR IN LIQUIDATION (35.8 PERCENT) WAS HIGHER THAN IT HAD BEEN AT THE END OF ANY OF THE LAST 9 FISCAL YEARS.

THE COSTS OF PRODUCING THE RELATIVELY FEW LASTING BUSINESSES HAVE BEEN HIGH. SBA EXPECTS TO LOSE ABOUT \$342 MILLION (EXCLUDING UNPAID INTEREST) ON ECONOMIC OPPORTUNITY LOANS DISBURSED THROUGH FISCAL YEAR 1980, ABOUT 33% OF ALL DISBURSED AMOUNTS. THE EXPENSES OF ADMINISTERING THE PROGRAM SHOULD BE ADDED TO THESE COSTS BUT ARE UNKNOWN BECAUSE SBA DOES NOT ACCOUNT FOR THEM SEPARATELY.

THE COSTS OF FAILURE TO UNSUCCESSFUL BORROWERS ALSO MUST BE CONSIDERED. MANY GAVE UP GOOD SALARIES TO ENTER BUSINESS AND INVESTED ALMOST ALL THEIR LIQUID ASSETS. WITH THE FAILURE OF THEIR BUSINESSES, THEY WERE IN WORSE ECONOMIC CONDITION THAN BEFORE THEY TOOK ON SMALL BUSINESS OWNERSHIP.

WHY PROGRAM COSTS AND THE RATE OF BORROWER FAILURE WERE HIGH

THE PROGRAM PRODUCED RELATIVELY FEW LASTING BUSINESSES FOR A VARIETY OF REASONS, SOME INHERENT IN THE PROGRAM'S NATURE, OTHERS RELATED TO THE WAY IT WAS MANAGED AND OPERATED. THE PROGRAM'S LEGISLATIVE HISTORY INDICATES THAT SBA WAS EXPECTED TO TAKE GREATER RISKS IN THE ECONOMIC OPPORTUNITY LOAN PROGRAM THAN IN ITS REGULAR BUSINESS LOAN PROGRAM. GREATER LOSSES AND A HIGHER FAILURE RATE THAN CUSTOMARY IN FEDERAL BUSINESS LOAN PROGRAMS COULD THEREFORE HAVE BEEN EXPECTED.

OUR REVIEW FOUND THAT BORROWERS' INEXPERIENCE, LOW CAPITAL INVESTMENT, AND DISADVANTAGEOUS LOCATIONS WERE SIGNIFICANT CAUSES OF BUSINESS FAILURES. HOWEVER, OUR REVIEW SHOWED THAT THE FOLLOWING THREE MANAGEMENT AND OPERATING DEFICIENCIES WITHIN SBA CONTRIBUTED TO THE PROGRAM'S LOW YIELD.

--LOAN OFFICERS AT SBA DISTRICT OFFICES FREQUENTLY DID NOT ASSESS LOAN APPLICANTS' BUSINESS PROJECTIONS, MANAGEMENT ABILITIES, AND THE SUFFICIENCY OF LOAN AMOUNTS.

--SBA'S GOALS SYSTEM WAS INCOMPLETE, FOCUSING EFFORTS ON LENDING IN QUANTITY BUT NOT ON LENDING EFFECTIVELY. GOALS WERE ESTABLISHED FOR MAKING LOANS BUT NOT FOR CREATING SUCCESSFUL BUSINESSES.

--IN AN EFFORT TO ALLOCATE LIMITED DIRECT-LOAN MONEY FAIRLY, SBA PLACED LOAN APPLICANTS WHO MET MINIMUM CREDIT STANDARDS ON WAITING LISTS AND FUNDED THEM IN TURN, AS MONEY BECAME AVAILABLE. AS A RESULT, LONG WAITING PERIODS FOR LOANS DEVELOPED AT MANY OFFICES, AND LESS QUALIFIED APPLICANTS COULD RECEIVE LOANS AT THE EXPENSE OF BETTER QUALIFIED APPLICANTS THEY PRECEDED ON THE WAITING LIST.

TO REDUCE LOAN LOSSES AND INCREASE THE NUMBER OF SUCCESSFUL BUSINESSES PRODUCED BY THE PROGRAM, WE RECOMMENDED THAT THE SBA ADMINISTRATOR

- REQUIRE BETTER ASSESSMENTS OF LOAN APPLICANTS' PROSPECTS FOR ESTABLISHING SUCCESSFUL BUSINESSES AND THE LOAN AMOUNTS MOST LIKELY TO HELP THEM REACH THIS GOAL;
- ESTABLISH PROGRAM GOALS WHICH DIRECT EFFORT TOWARD PRODUCING SUCCESSFUL, LASTING BUSINESSES AND MONITOR THE PROGRESS OF THE PROGRAM TOWARD REACHING THESE OBJECTIVES; AND
- UPGRADE MINIMUM STANDARDS FOR THE PROGRAM SO THAT ONLY THE BEST QUALIFIED APPLICANTS WHO COULD BE FUNDED WITHIN A REASONABLE TIME WERE ADMITTED TO THE WAITING LISTS.

REMEDIAL MEASURES COULD HAVE HELPED BORROWERS AND IMPROVED THE PROGRAM'S PRODUCTIVITY

BECAUSE THE ECONOMIC OPPORTUNITY LOAN PROGRAM HAD SOCIAL AS WELL AS ECONOMIC GOALS, AND SERVICED BUSINESSES WHICH COULD NOT QUALIFY FOR OTHER BUSINESS LENDING, SOME DEPARTURES FROM TRADITIONAL LENDING PRACTICES SEEMED WARRANTED.

SBA HAS TRIED SOME SPECIAL ASSISTANCE TECHNIQUES--REFINANCING OF TROUBLED LOANS AND GRANTING DEFERMENTS TO BORROWERS--BUT WITHOUT MUCH SUCCESS. THREE OTHER METHODS FOR ASSISTING BORROWERS--GRACE PERIODS ON INITIAL REPAYMENTS; GRADUATED REPAYMENT SCHEDULES UNDER WHICH LOAN PAYMENTS WOULD INCREASE AS BUSINESSES BECAME BETTER ESTABLISHED; AND EARLY, INTENSIVE MANAGEMENT ASSISTANCE--HAVE NOT BEEN ADEQUATELY TESTED BECAUSE THEIR USE HAS BEEN TOO LIMITED.

BORROWERS DID NOT USUALLY ACCEPT THE MANAGEMENT ASSISTANCE OFFERED TO THEM. IN ADDITION, THE ASSISTANCE CAME TOO LATE--AFTER THEY HAD ALREADY MADE CRUCIAL DECISIONS ON LOCATING AND OPERATING THEIR BUSINESSES AND ON HOW TO SPEND THE LOANS. THE ASSISTANCE PROVIDED WAS ALSO TOO LIMITED--NOT OF A SCOPE OR DURATION CONSISTENT WITH BORROWER NEEDS. MOST BORROWERS THAT WE INTERVIEWED REPORTED THAT THE MANAGEMENT ASSISTANCE THEY RECEIVED HAD LITTLE EFFECT ON THEIR BUSINESSES.

WE RECOMMENDED THAT THE SBA ADMINISTRATOR TEST THE EFFECTIVENESS OF THE THREE TECHNIQUES MENTIONED ABOVE FOR ALLEVIATING BORROWERS' UNDERCAPITALIZATION AND INEXPERIENCE.

WE ALSO RECOMMENDED THAT THE ADMINISTRATOR CONSIDER APPLYING OUR RECOMMENDATIONS TO MINORITY BUSINESS LENDING IN SBA'S 7(a) PROGRAM, WHICH ALSO HAD A HIGH RATE OF BORROWER DEFAULT AND WHICH IS ADMINISTERED BY THE SAME ORGANIZATIONAL UNITS AND UNDER THE SAME PROCEDURES AS THE ECONOMIC OPPORTUNITY LOAN PROGRAM. TWENTY PERCENT OF MINORITY 7(a) LOANS DISBURSED THROUGH FISCAL YEAR 1978 HAD BEEN CHARGED OFF OR WERE IN LIQUIDATION AS OF MAY 1979.

NOW THAT THE ECONOMIC OPPORTUNITY LOAN PROGRAM HAS BEEN CONSOLIDATED WITH OTHER LOAN PROGRAMS UNDER SECTION 7(a), IT WOULD BE APPROPRIATE AND TIMELY FOR SBA TO CONSIDER OUR RECOMMENDATIONS IN DRAFTING ANY REVISIONS TO ITS REGULATIONS OR PROCEDURES UNDER THIS SECTION OF THE ACT.

RECOMMENDATION TO THE SENATE AND
HOUSE COMMITTEES ON SMALL BUSINESS

FINALLY WE RECOMMENDED THAT THE CONGRESSIONAL OVERSIGHT COMMITTEES MONITOR SBA'S IMPLEMENTATION OF OUR RECOMMENDATIONS FOR MANAGEMENT IMPROVEMENTS AND THEIR IMPACT ON PROGRAM RESULTS. WE SAID THAT IF RESULTS DID NOT IMPROVE, THE COMMITTEES SHOULD DETERMINE WHETHER THE OBJECTIVES OF THE ECONOMIC OPPORTUNITY LOAN PROGRAM COULD BE ACHIEVED MORE EFFICIENTLY BY RECOMMITTING THE PROGRAM'S FUNDS TO OTHER FEDERAL PROGRAMS FOR SOCIALLY OR ECONOMICALLY DISADVANTAGED BUSINESS OWNERS.

SBA COMMENTS ON OUR REPORT

IN ITS WRITTEN COMMENTS ON OUR REPORT, SBA SAID THAT THE PROGRAM "AS A WHOLE" HAD NOT FAILED. SBA SAID THAT THE ECONOMIC OPPORTUNITY LOANS ARE THE HIGHEST RISK PORTFOLIO. THEY TURNED BACK TO US THE QUESTION OF WHAT PERCENTAGE OF SUCCESS SHOULD BE CONSIDERED ACCEPTABLE IN THIS TYPE OF PROGRAM.

SBA DID NOT INDICATE WHETHER IT WOULD IMPLEMENT OUR RECOMMENDATIONS NOR DID IT PRESENT ANY ADDITIONAL FACTS OR VIEWS WHICH WOULD CAUSE US TO MODIFY OUR CONCLUSIONS OR RECOMMENDATIONS. SBA DID SAY, HOWEVER, THAT ONE OF THE MOST USEFUL CHANGES IT COULD MAKE WOULD BE TO INFORM LOAN APPLICANTS OF HISTORICAL PROGRAM RESULTS AS PRESENTED IN OUR REPORT SO THAT THE APPLICANTS COULD

BETTER ASSESS THE WISDOM OF STARTING A BUSINESS OR TAKING ON MORE DEBT. WE AGREED. IN RESPONSE TO SBA'S QUESTION ABOUT WHAT IS AN ACCEPTABLE RATE OF SUCCESS, WE STATED THAT SBA, AS THE AGENCY ENTRUSTED WITH THE MANAGEMENT OF THE PROGRAM, SHOULD DEFINE ACCEPTABLE PERFORMANCE.

WE ALSO NOTE THAT SBA HAS RECENTLY DISCONTINUED THE USE OF DOLLAR LOAN MAKING GOALS IN THE ECONOMIC OPPORTUNITY AND OTHER LOAN PROGRAMS. SBA HEADQUARTERS HAS ADVISED ITS REGIONAL OFFICES THAT THEY WILL NOT BE EVALUATED ON DOLLAR GOALS AND THAT THEIR PROGRAM LEVELS SHOULD BE REALISTIC. IN SO DOING, SBA SHOWED SIGNS OF HEEDING AN ADMONITION GIVEN BY ITS OWN PROCEDURES MANUAL:

"FROM A SOCIOECONOMIC VIEWPOINT, THE INDISCRIMINATE APPROVAL OF LOANS AT A HIGH VOLUME AND LOW RATE OF SUCCESS CAN DO NOTHING BUT IMPAIR OUR RELATIONSHIP WITH THE SMALL BUSINESS CONCERNS AND COMMUNITIES THAT WE ARE ATTEMPTING TO HELP. WHEN A LOAN IS MADE WITH LITTLE OR NO CHANCE OF SUCCESS AND THE BUSINESS SUBSEQUENTLY FAILS, NOT ONLY HAS THE BORROWER BEEN BURDENED WITH A SUBSTANTIAL DEBT WHICH CANNOT BE REPAYED BUT THE ENTIRE COMMUNITY HAS BEEN GIVEN CAUSE TO QUESTION OUR JUDGMENT AND CREATE A LACK OF CONFIDENCE IN US TO THE DETRIMENT OF OUR PROGRAMS IN THAT COMMUNITY, AS WELL AS IN OTHERS THROUGHOUT THE COUNTRY."

WE THINK THIS IS A WELL EXPRESSED STATEMENT OF WHY THE LENDING PRACTICES FOLLOWED IN THE ECONOMIC OPPORTUNITY LOAN

PROGRAM SHOULD NOT CONTINUE UNCHANGED. WE CONTINUE TO BELIEVE
THAT OUR RECOMMENDATIONS SHOULD PLAY AN IMPORTANT ROLE IN GUIDING
THESE NEEDED CHANGES.

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MR. CHAIRMAN, THIS CONCLUDES MY PREPARED STATEMENT. WE WILL
BE GLAD TO RESPOND TO ANY QUESTIONS.