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Testimony for the Record submitted to
The Senate Committee on Small Business and Entrepreneurship

For the hearing:
Reauthorization of the SBA's Access to Capital Programs
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Chairman Rubio and Ranking Members Cardin, thank you for convening this important hearing to discuss the US Small Business Administration's Capital Access programs. My comments are focused on the SBA Community Advantage (CA) program, a pilot launched in 2011 under the SBA's 7(a) loan guarantee program that has effectively and efficiently increased SBA lending in emerging markets and underserved communities and should be granted full program authority within SBA's flagship 7(a) program.

I represent both the largest CA lender in the nation, CDC Small Business Finance (CDCSBF), and the Mission Lenders Working Group (ML Working Group)¹. The ML Working Group was formed in 2015 by a group of active CA lenders to share best practices and to inform the SBA, and each other, of what is working in the program and what could be improved. As a group, we have been responsible for the creation and retention of over 20,000 jobs through CA lending and nearly half (49%) of the CA loans funded. The group is comprised of knowledgeable small business lenders, representing all the three types of lenders allowed in the program (noted below). All of the organizations are seasoned small business lenders who understand what it takes to reach, finance, and grow sustainable small businesses in emerging markets and all of us are committed to moving our borrowers into a banking relationship so we can free up our capital to reach more good businesses who aren't yet bankable.

CDCSBF is celebrating 40 years of supporting small businesses. As an economic development organization, CDCSBF provides a number of programs and products that support underserved small businesses and the entrepreneurial ecosystem. We are advocates for ALL small businesses but have a particular passion for and belief that small business ownership is a tool for closing the racial wealth gap. Headquartered in San Diego, California, we provide services throughout the State and in Arizona and Nevada. These

¹ See attached description of the Mission Lenders Working Group

programs include an array of SBA programs such as: the SBA 504 commercial real estate product for small business owner-occupants (CDCSBF is the largest 504 lender in the country); 7(a) Community Advantage, and the SBA Microloan Program. In fact, in 2018, CDCSBF was recognized as the Jody C. Raskind SBA Microlender of the year. CDCSBF also controls or manages six other corporations, including a Community Development Financial Institution (CDFI).

Through these multiple programs CDCSBF has provided over \$13 billion in capital to small businesses and has created over 200,000 jobs. That's 13 jobs per day, everyday, for 40 years! The organization also provides business advising or "Technical Assistance" and in the last two years has delivered nearly 14,000 of Business Advising to small businesses.

What is the Community Advantage Program

The SBA Community Advantage Pilot Program was launched in February 15, 2011.

For the first time the SBA's flagship 7(a) program was extended to experienced mission lenders, with the goal of assisting small businesses that were not yet "bankable" but needed access to affordable and responsible capital. This was an acknowledgement that the lending industry needed to do a better job in providing small dollar loans to businesses in underserved communities, or those businesses classified as "emerging markets."

The programs goals, per the initial Community Advantage Participant Guide were:

- To increase access to credit for small businesses in underserved markets;
- To expand points of access to SBA 7(a) loans by engaging non-traditional mission lenders with experience working in underserved markets;
- To provide management and technical assistance to small businesses as needed; and
- To manage portfolio risk by utilizing the underwriting knowledge of mission lenders with successful track records lending in underserved markets.

As noted above, the critical component of the program was to expand the 7(a) program to mission lenders. The SBA defined mission lenders as falling into one of three groups: SBA certified development companies (CDCs); SBA microlenders; and Community Development Financial Institutions (CDFIs). The Administration understood that these lenders were the best situated to meet the capital needs of the underserved business populations not being met by traditional SBA lenders. Mission lenders have a deep knowledge of their communities, are accountable to their communities via resident representation on their board of directors, and, as an explicit purpose and mission, assist small businesses that are located in underserved areas or are owned by woman and minority entrepreneurs.

While guided by the Standard Operating Procedures (SOP) of the traditional 7(a) program, lenders under the Community Advantage program have different, or additional, requirements or parameters which traditional 7(a) lenders are not subject to. These include:

- \$250,000 Maximum loan limit

- 60% of loans must be to a designated Target Market²
- Cash Loan Loss Reserve requirements of 5% for the guaranteed portion sold and 5% for the un-guaranteed portion. This was recently increased from 3% to 5% for the guaranteed portion
- A 12-month period of perfect payments by a borrower before same institution debt refinance allowed
- Technical Assistance recommended
- Can serve applicants with an SBSS score as low as 120
- Allowed a spread of 6% above Prime (this changed from 4% one year into the program)

Regarding the 6% spread, mission lenders were provided this consideration because of the increased cost of delivering this program to the riskiest borrowers and the close relationship required between the mission lender and the small business client. In addition, almost all CA lenders provide business advising at no charge to the small business client. In fact, in the report, "Evaluating Technical Assistance and Economic Opportunity Outcomes of the Community Advantage Pilot Program" prepared for the SBA in May 2018, the relationship with the client and the business advising component of the program are noted as key factors in the successful performance of the CA program.

Impact of Community Advantage

CDC Small Business Finance was one of the first six mission lenders approved by the program and has consistently been one of the leading CA lenders in the nation both in terms of loan volume and performance. Through March 2019 CDCSBF had funded 656 CA loans for over \$91 million. More than 70% of our CA loans financed are to businesses in an SBA designated "underserved or target market" – including 51% of our loans to start-up businesses (less than two years old), over 27% of our CA loans financed businesses located in low-moderate income communities and/or have a workforce that is at least 50% low-moderate income - and to date the businesses we financed with CA loans have supported over 4,700 jobs. As a CA lender, we intentionally assume risk that traditional banks would/could not, but our intensive underwriting process, attention to the needs of each business and each client keeps our loans performing and our portfolio sound – thus less than 3% of our CA loans have been charged-off.

While not currently considered target markets under the SBA CA program, 12% of CDCSBF's CA loans are to Latino-owned businesses, 8% to Black-owned businesses and 29% to women-owned businesses. CDCSBF targets its outreach to these markets because historically, it is these groups that have not been served well by traditional financial institutions and have not had access to affordable and responsible capital. The Community Advantage program has allowed mission lenders to serve woman and minority populations with a main street product, that provides the small business fair and responsible capital and starts them off in the continuum of responsible capital.

² Target Market - Low-to-Moderate Income (LMI) communities; Businesses where more than 50% of the full-time workforce is low-income or reside in LMI census tracts; Empowerment Zones and Enterprise Communities; HUB Zones; Promise Zones; New "start-up businesses (Firms less than two years in business); Businesses eligible for SBA Veteran's Advantage; and Business located in Opportunity Zones (added 10/1/2018).

As an industry, since the CA program was launched in 2011, over 5,200 loans have been funded, totaling over \$696 million (through March 12, 2019). The average CA loan size is just under \$133,000 as compared to the average 7(a) loan, which is \$417, 300. While CA lenders may lend at 6% above prime, the majority of loans have been 4% to 4.5% above Prime. CA lenders are required to target at least 60% of their lending to the SBA's Target Markets and more than 70% of all CA loans have been in the underserved Target Markets.

One of greater impacts of the Community Advantage program has been its success in lending to the Black and Latino small business community. For example, in fiscal year 2018, 12% of all CA loans were to Black-owned businesses and 17% to Latino businesses. Compare this to the 7(a) SBA Express Loans under \$250,000, where loans to Black businesses in fiscal year 2018 represents 5% of the lending under \$250,000 and 10% to Latino businesses.

There are currently 99 active CA lenders across the country and a CA loans has been made in 45 different states. While there is an understanding that CA loans are riskier, the cumulative charge-off rate on CA loans through FY 2018 has been 1.5% and the cumulative default rate has been 3.6%. This rate is significantly lower than what the SBA anticipated when the CA pilot was first conceived, which I credit to the experience of CA lenders like CDCSBF.

As a percentage of total 7(a) lending from the launch of CA through FY 2018, the CA loans represents .36% of all 7(a) lending; approximately one-third of one percent. Yet this small program has made an incredible impact in the lives of many small business owners.

Continuum of Capital within the Entrepreneurial Ecosystem

Mission lenders play an important role in the continuum of capital. They provide affordable and responsible capital to small businesses and prepare them for the next stage of financing, which most often is conventional financing from a bank or a larger SBA loan from a bank or traditional financial institution. In other words, mission lenders are the bridge to bank financing. For example, the average length in portfolio for Community Advantage loans for CDCSBF is thirty-months and 16% of the portfolio has prepaid (representing 108 loans). Nearly 50% of those pre-pays were refinanced by banks.

Many other CA lenders have target goals of moving their Community Advantage client through and out of their portfolio. MoFi, which operates in Montana and Idaho, has a goal of referring their CA clients to a bank in 28 months. Evergreen CDC in Washington State has a similar goal of 24 months. Traditional banks are an important partner to mission and Community Advantage lenders. First, banks are the source of lending capital for mission lenders. Mission lenders are not deposit taking institutions, so banks are a vital source of lendable capital. Most bank partners are champions of the CA program, as they recognize that the money they lend to a mission CA lender will have a 75% or 85% guarantee. Second, for most mission lenders, 30% to 50% of their referrals come from banks. For CDCSBF, this has historically been 50%, with one in four (25%) of bank referrals resulting in a funded loan. This compares to a 10% funding rate from all other referral sources.

Mission lenders therefore are important starting points in the continuum of capital. We expand the credit market by allowing more small businesses access to capital and as

mission lenders committed to their success, improve their chances of survival. In most cases small businesses would not get started, "if not but for" mission lenders and the CA program.

As noted above, mission lenders look to banks to refinance their clients out of their portfolio. Bank refinancing is the next step in the continuum of capital after a loan from a mission lender. However, equally important for mission lenders is that the CA program has allowed the industry to sell the guaranteed portion of the loan. This is critical, as it allows the lender to re-cycle the capital and continue making loans in their community. For this reason alone, the CA program has been a game-changing product. CA lenders do not have to continuously borrow new capital from banks if they are able sell 85% of the loan. This allows capital to be leveraged as high as five or six to one. For example, a \$5 million loan from a bank to a CA mission lender can result in over \$27 million in lending (with all loans under \$150,000 and all guaranteed portions sold).

Finally, maybe the most crucial roles mission lenders and the CA program play in the continuum of capital is two-fold; being the first option of alternative and responsible capital as opposed to high cost capital (on-line or fintech lenders being the most recent) and second, assisting small businesses trapped in high cost loans escape their situation through refinancing them with responsible and affordable capital as well as business advising/education.

Nearly one-third of CDCSBF's CA loans include refinance of some type of high interest rate loan, whether it be from an on-line lender or a merchant cash advance. The interest rates on these loans range from 17% to as high as 94%, with APRs in the triple digits, when fees are included. Attached is an article entitled "Failing to Grasp Loan Terms Can Be Costly to Companies" from the San Diego Business Journal³. The article details the story of a CDCSBF client, Kindred Bravely, and their regret of taking an on-line loan. CDCSBF was able to assist them, and this small business was recently refinanced by a community bank, First Foundation Bank.

Recommended Changes to the Program

As the Committee looks to modernize SBA and keep it relevant, the Community Advantage program and its current delivery system needs to be made a permanent part of the 7(a) statute.

The mission lenders that are part of the Community Advantage program applaud the SBA for launching this pilot program. As noted above, mission lenders were selected for their experience and expertise in delivering capital to underserved communities. We deploy more than just capital; we provide up-front business advising and continued support through-out the life of the loan. For example, at CDCSBF, if the client is part of the underserved Target Market and not qualified for a loan, we take the extra step of referring the entrepreneur to our internal business advising staff, who work with them and prepare them for a loan. For example, in fiscal year 2018, we funded forty businesses for just under \$5 million which we had "off-ramped" from our sales pipeline (they were not "loan-ready") to our business

³ See Attached Article

advising platform. This is what differentiates Community Advantage mission lenders from traditional SBA lenders.

In recognizing this distinction and partnering with mission lenders the SBA is staying relevant to the fastest growing segment of the small business population; those located in low-moderate communities, start-ups, and entrepreneurs of color.

Since the program launched, it has undergone numerous changes and has had at least four Participant Guides published. Industry and the SBA have had a good working relationship and many of the changes have been the result of the two groups working together. This includes allowing the use of Lender Service Providers for CA lenders (initially disallowed), increasing the spread over Prime from 4% to 6% and developing the concept of the Community Advantage Associate.

Most recently, on October 1, 2018 SBA Notice 2018-0008 went into effect. This notice extended the pilot to September 30, 2022 and added Opportunity Zones as an eligible Target Market, both very positive changes. However, other changes in this Notice, and other earlier changes, we believe, need to be re-examined and further discussed with industry. The below are a list of recommended changes to the program that would result in increased lending to the small business community, specifically in the designated Target Markets. We also believe that these changes do not result in an elevated risk to the SBA or the 7(a) program.

Reducing Restrictions to Same Institution Debt Refinancing

To better serve the small business client, particularly those trapped in high-cost loans, it is recommended that the SBA revert back to the 6-month, same institution debt requirement in place prior to the issuance of SBA Notice 2018-0008. Further, we encourage dialogue as to how we can work together to improve the process of getting small businesses out of high cost loans.

The new rule states that for CA lenders to refinance a same institution, non-SBA guaranteed loan, the SBA will require "a transcript showing the due dates and when payments were received for the most recent 12 month period, rather than six months. If there are any late payments in the most recent 12 month period, the debt may not be refinanced with a CA loan." The new rule makes it more difficult for a CA lender to be nimble in responding to the needs of a small business, and it is unclear what the SBA is seeking to address in making this rule change.

It is worth noting that over 80% of the CA lenders surveyed by the Mission Lenders Working Group reported that a significant number of prospective borrowers are seeking to refinance a high-priced loan from an online lender. Several CA lenders reported that 25-30% of these businesses are near a financial breaking point due to unaffordable daily automatic payments, requiring a quick refinance of the unaffordable debt in order to stabilize the business and prevent it from going under. Some CA lenders offered short-term bridge loan as immediate relief while they processed a CA loan for the borrower. This process was feasible under the previous rule which allowed same-institution debt refinancing after six months. With the new rule requiring 12 months of on-time payment history before same-

institution debt may be refinanced into a CA loan, it is more difficult, and less feasible, for CA lenders to provide bridge products and provide relief to a small business.

We suggest that the Administration work with CA mission lenders to streamline the ability to refinance same-institution debt, particularly when it comes to high cost loans. This can include reverting back to the six-month rule or even developing a pilot program when it comes to refinancing loans that are over a certain APR.

For example, CDCSBF worked and funded a pre-school in San Diego that had three on-line, high cost loans, one with a daily withdrawal of \$710. The total monthly payments for the three loans were over \$19,800 per month (on outstanding debt of approximately \$150,000). Working with CDCSBF, the wife and husband team that co-owned the pre-school were able to drop their monthly payments to \$3,000, saving the small business over \$16,000 per month. However, the SBA loan took over three months to close and fund. If there had been a streamline process where CDCSBF could have provided a bridge loan in the first month that could be taken out by the SBA CA loan at closing, the couple would have saved two months' worth of payments, or \$32,000!

Review Loan Loss Reserve Required for Loans Sold on the Secondary Market

There have been at least three changes to the Loan Loss Reserve (LLR) requirement since the inception of the program. Initially, the LLR required mimicked the one for the SBA microloan which is 15%. This 15% was applicable to the un-guaranteed portion. That changed to 5% on the un-guaranteed and 3% on the guaranteed portion, if the loan was sold. Most recently this latter LLR was increased to 5%, resulting in a 5% LLR for the un-guaranteed portion and 5% on the guaranteed portion if the loan is sold. This is a required cash LLR.

This additional LLR requirement will have an impact on the unrestricted cash of **all** CA lenders selling loans on the secondary market without regard for their performance as a lender or the health of their portfolio.

As CA lenders actively grow their portfolios, the funds that would have otherwise been available to finance more CA loans to businesses in underserved businesses will now be diverted to cover a lender's LLR requirement. Selling CA loans into the secondary market has been an important way for mission lenders to raise loan capital, finance more businesses, and maximize the impact of CA as a financing tool.

For example, CDCSBF funded \$12,637,677 in CA loans since the new 5% rule took effect. If we assume a blended average of an 80% guarantee, it equates to \$10.1 million being under a guarantee, which CDCSBF will sell in the secondary market. The new additional 2% (moving from 3% to 5%) LLR requirements results in over \$202,000 in cash from CDCSBF that has to be deposited into the LLR.

The combination of the increased LLR requirement and potential secondary market softening could impact the decision of CA lenders to continue being active SBA lenders. If lenders decide it would be financially prudent to hold their CA loans rather than selling them into the secondary market, they give up the benefit of increasing liquidity to make more loans and

serve more businesses in underserved markets. This isn't a viable option and not the intended consequence desired by the SBA or the mission lending industry.

We recommend that SBA look at reducing the 5% LLR requirement on CA lenders that meet certain performance thresholds. This standard is used in the SBA Microloan program, where high performing intermediaries can have their LLR reduced from 15% to 10%. A similar policy should be applied to CA lenders.

Continued Training for Community Advantage Lenders

We recommend that SBA provide upfront and ongoing training and technical assistance to CA lenders. We appreciate that SBA recently offered two mandatory online trainings for CA lenders and hope there are additional trainings being planned. While online trainings and webinars can be effective, there is no substitute for in person trainings especially for a new initiative like CA. We would welcome the opportunity to work with SBA to identify areas where additional training and/or technical assistance would be beneficial.

We also support and encourage additional resources for the SBA. We recognize that it is a challenge for the Administration to provide adequate oversight with existing resources. Under the CA program, 100 new lenders were added to their portfolio, yet no additional resources were provided. The Administration would benefit from additional staff to assist in oversight. In addition, mission lenders, particularly those that are more experienced and have performed well in the program, are willing to be trainers and mentors to active and new CA lenders.

Develop an Alternative Risk Assessment Protocol for CA Lenders.

Mission lenders in the program are open to working with the SBA's Office of Credit Risk Management (OCRM) to develop a risk assessment protocol for CA Lenders. CA lenders are asked to finance the businesses left behind by traditional 7(a) lenders, resulting in an inherently riskier portfolio of SBA loans. This is especially true when financing start-up businesses, which may be as high as 50% in most CA lenders portfolio. While the new CA rules work to mitigate CA portfolio risk there is no guidance to lenders regarding what SBA considers an appropriate level of risk. Industry and the MLWG would like to work with the Office of Capital Access and OCRM to develop a risk assessment protocol that recognizes the capacity of mission driven lenders to manage risk, to explore what 'acceptable' risk looks like, and come up with PARRIS scoring and peer comparisons that work for CA lenders.

Raise the Maximum Loan Size to \$350,000

Many mission lenders in the program have requests higher than \$250,000 and have to provide two or more loans to meet the need of their small business client (this was the case with the pre-school discussed above). Raising the maximum to \$350,000 will allow additional affordable capital to reach the small businesses in underserved areas. The \$350,000 cap also puts the CA program in line with other 7(a) lenders under the Small Loan Advantage Program, of which the CA program is a subset.

To mitigate risk to the program, the administration can place performance requirements on those CA lenders that are eligible for the \$350,000 maximum. It could also require that loans above \$250,000 be processed as non-delegated and be reviewed by the loan processing center.

Adding Demographic Populations to Target Market

The CA Pilot program was launched with the intention of providing affordable and responsible capital to underserved small businesses. The program has been very successful in delivering to the Target Market established by the SBA. However, we strongly believe that the Target Market definition needs to be expanded to include three critical groups; women and Black and Latino owned businesses.

Studies have demonstrated that these three groups have consistently faced barriers in accessing capital. The SBA monitors/measures performance in lending to this groups and has historically encouraged lending to this demographic via past and current programs. In addition, many of the CDFIs that participate in the CA program focus on one, two, or all three of these groups and are held accountable by the CDFI Fund to a 60% lending threshold to that market. We believe and encourage congruency between federal programs that are working with similar organizations for the delivery of programs.

Permanency for CA Program

The CA program is eight years old and has met the expectations of the administration. It has delivered nearly \$700 million in affordable and responsible capital to small businesses in the emerging markets that are historically shut out of the traditional lending markets, all with a loss rate of less than 2%. It has developed a core of high performing mission lenders that are now experienced in SBA lending and are reaching markets not met by banks. The program has also allowed these lenders access to the secondary market, so that they can re-capitalize quickly by selling the guaranteed portion of the loan, thus leveraging their capital five-fold.

The SBA Express program, whose lending cap is being requested to increase from \$350,000 to \$1 million, was a pilot program for nine years before becoming permanent (1995-2004). Making the CA program permanent, provides the SBA with a focused small dollar program that reaches deep into low-moderate income communities, minority and woman owned businesses, as well as start-up businesses. This can, and should be, the relevant small dollar 7(a) program for the SBA, particularly as other programs aim for larger markets.

Permanency is also important so that the program can grow. Without the security and knowledge that the program is going to become permanent, many mission lenders are reluctant to invest in the program. Making the decision to be an SBA lender is one that cannot be taken lightly and requires both intense human and capital resources.

To address the Administration concerns about the program growing too quickly, industry is willing and open to work with the SBA in scaling the program appropriately. First, SBA needs to be provided additional resources to adequately manage the program appropriately. Second, new lenders can be phased in, with a limit on the number of new lenders allowed access to the program every year. This allows the SBA to properly train and prepare the new lenders. New lenders can also be paired with an experienced CA lender. Finally, there can be a maximum limit on CA lenders in the program. This is similar to the parameters set within the SBA microloan program.

While there are some that believe there needs to be continued study, the impact of the program has been significant in a very short time frame and the results have been impressive. The program is serving the Target Market (or emerging markets); the CA program places the borrower in position to obtain financing from another source, such as a traditional bank; and business growth through the CA program has far-reaching impacts on borrowers and their communities.

In closing, I would like to quote from the study requested by the SBA which is referenced above and was published in May of 2018. One of the conclusions of the study states:

*The combination of what the CA program provides – financing with reasonable terms at a critical stage in a business’s trajectory, through a trusted and accessible partner, with targeted technical assistance – makes the CA program an effective and important resource for small businesses.*⁴

Thank you for the opportunity to submit testimony and I am available to answer any questions or provide additional information.

⁴ “Evaluating Technical Assistance and Economic Opportunity Outcomes of the Community Advantage Pilot Program,” Final Report, May 2018; Prepared by Industrial Economic Incorporated; Prepared for the US Small Business Administration, Office of Performance Management and Office of Capital Access.

Attachments

- I. Overview of Mission Lenders Working Group
- II. Article – San Diego Business Journal, “Failing to Grasp Loan Terms Can Be Costly to Companies”