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National Association of Federally-Insured Credit Unions

December 27, 2022

Dianna Seaborn
Director, Office of Financial Assistance, Office of Capital Access
Small Business Administration
409 3rd St SW
Washington, DC 20416

RE: Affiliation and Lending Criteria for the SBA Business Loan Programs (RIN 3245-AH87)

Dear Ms. Seaborn:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the Notice of Proposed Rulemaking (NPR) issued by the Small Business Administration (SBA) regarding the proposal to amend various regulations governing SBA's 7(a) Loan Program and 504 Loan Program, including use of proceeds for partial changes of ownership, lending criteria, loan conditions, reconsiderations, and affiliation standards (Affiliation Proposed Rule). NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 133 million consumers with personal and small business financial service products. NAFCU and its member credit unions appreciate the opportunity to provide input on this NPR and urge the SBA to safeguard the 7(a) Loan Program by rescinding or pausing this rulemaking until its impact in relation to Small Business Lending Companies (SBLCs) is better understood. NAFCU supports the portions of this rulemaking that provide flexibility and facilitate the origination of small-dollar commercial lending. However, the SBA should avoid the inclusion of political appointees in the lending process.

General Comments

NAFCU has consistently worked with the SBA to identify opportunities to streamline regulations and provide support to credit unions to increase the volume of SBA lending and thereby increase access to capital for small businesses throughout the country. Since 2015, NAFCU and the SBA have entered into a Strategic Alliance Memorandum (SAM) aimed at strengthening credit unions' ability to fund loans for small businesses in their communities. Although NAFCU is supportive of aspects of this proposed rule to the extent that it reduces burdens and costs on credit union SBA lenders, NAFCU is concerned about the timing of the proposed rule.

On November 7, 2022, shortly after the SBA issued the Affiliation Proposed Rule, the SBA published a notice of proposed rulemaking to lift the moratorium on licensing new SBLCs and add a new type of entity called a Mission-Based SBLC (SBLC Proposed Rule). The rescission of the moratorium on the licensing of new SBLCs would allow non-depository institutions, including financial technology companies (fintechs) and other alternative lenders, to apply for a license to participate in the SBA's 7(a) Loan Program. The simultaneous loosening of lending requirements and opening 7(a) lending to underregulated, fraud-prone fintechs would represent a major shift in SBA lending, the impacts of which may be significant, and which have not been properly examined.

As a general matter, NAFCU supports the recommendations made in the joint letter led by the National Association of Government Guaranteed Lenders (NAGGL) to Senator Cardin, Senator Paul, Representative Velázquez, and Representative Luetkemeyer. NAFCU has perspectives on the individual proposals contained in the Affiliation Proposed Rule, which it will provide here, but urges the SBA to consider the Affiliation Proposed Rule and the SBLC Proposed Rule as inextricably linked. NAFCU urges the SBA to delay issuance of a final rule for either proposal until it has adequately considered the impacts of each rule upon the other, and the combined impact of both.

Underwriting Standards

In the Affiliation Proposed Rule, the SBA is proposing to incorporate a new requirement that lenders must underwrite SBA loans using the same appropriate and prudent generally acceptable commercial credit analysis processes and procedures used for their similarly-sized, non-SBA guaranteed commercial loans where they bear all risk of loss in the case of loan default.

NAFCU appreciates the efforts to streamline lending requirements and resolve a situation in which an SBA lender is beholden to two sets of commercial credit analysis processes and procedures, those of the SBA and those of their prudential regulator. Simplifying regulations is crucial to expanding SBA lending, as shown by a recent survey in which 30 percent of NAFCU respondents said that the complexity of the SBA application process was a factor in their decision not to become an SBA certified lender, with 22 percent listing specific SBA regulations as a factor.[1] However, in practice this new requirement around credit analysis processes could result in an unlevel playing field. While depository SBA lenders such as credit unions are subject to the underwriting requirements found in the regulations of their prudential regulators such as the National Credit Union Administration (NCUA), non-depository lenders without a prudential regulator are not bound to a separate set of underwriting requirements intended to control risks and ensure that financial institutions maintain adequate capital. This issue is of particular concern for credit unions as demonstrated by NAFCU's 2022 Report on Credit Unions, where 89 percent of NAFCU respondents reported that they do not believe their credit union is operating on a level playing field with nonbank small business loan originators.[2]

[1] NAFCU Report on Credit Unions, 2022.
[2] NAFCU Report on Credit Unions, 2022.

NCUA Regulations § 723.4, which discusses a federal credit union's commercial loan policy, requires a federal credit union to adopt and implement a comprehensive written commercial loan policy and establish procedures for commercial lending for all loans greater than $50,000. This commercial loan policy must include underwriting standards commensurate with the size, scope, and complexity of the commercial lending activities and borrowing relationships contemplated. If the new underwriting requirement found in the Affiliation Proposed Rule were put into effect, credit unions would still be required to evaluate their SBA loans using these standards. Conversely, a fintech that was granted an SBLC license would be free to originate 7(a) loans using the same commercial credit analysis processes and procedures used for their similarly-sized, non-SBA guaranteed commercial loans, which, again, would be free from the type of federal regulatory framework intended to protect lenders, borrowers, and the loan programs. This mismatch would result in a variety of increased risks to SBA lending.

Depository SBA lenders such as credit unions, which have a long track record of prudent partnership in the SBA loan programs, would be placed at a competitive disadvantage. Non-depository SBLC lenders implementing less stringent underwriting requirements would expend fewer resources to offer SBA loans and thus be able to offer more favorable terms on these loans. Small businesses would naturally gravitate toward these riskier lenders, slowly reducing the demand for SBA loans from depository institutions and eventually reducing the number of depository institutions that offer SBA loans. This would run counter to the purpose of the rule and exacerbate the current decrease where "the number of participating 7(a) Lenders has steadily decreased each year from FY 2010 with 2,034 Lenders to FY 2019 with 1,632 Lenders."[3] This would have a detrimental impact on the very communities that the proposed rule intends to help, minority and disadvantaged borrowers, who would have less access to affordable business lending as fewer credit unions offer SBA loans. Individual borrowers could also be put at risk, with borrowers that are not creditworthy taking on loans that they are unable to repay. The 7(a) Lending Program itself would face increased risk from fraud, credit losses, and reputational risk. This would have widespread implications for the larger financial markets and is a serious risk to the future of small businesses. All of these consequences should be considered by the SBA prior to issuing a final rule and NAFCU urges the SBA to delay the rulemaking process until they have been fully evaluated.

As noted in the recent report on fintechs from the U.S. Department of the Treasury "As a general principle, non-bank firms and insured depository institutions (IDIs) that engage in the same activities to provide consumer financial services should be held to the same risk-based standards with respect to those activities. A lack of sufficient clarity regarding the application of existing law or supervisory standards to available credit underwriting approaches can impact the

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[3] *See* 87 FR 64724.

willingness of responsible lenders to use those approaches."[4] The SBA should apply this principle to small business lending and hold to it throughout this rulemaking process.

Business Credit Scoring Model

SBA also proposes adding language to § 120.150 to permit Lenders to use a business credit scoring model such as the SBA's Small Business Scoring Service (SBSS) credit scoring model. NAFCU supports this aspect of the Affiliation Proposed Rule, as it would provide credit unions with a simplified process to underwrite smaller loans in a more cost-effective manner. Specifically, credit unions would be able to improve credit analysis processes by leveraging a scoring model over the traditional "spreading" of multiple years of financial data, thus requiring less documentation and effort for both the borrower as well as the lending team. As a result, underwriting turnaround times would be dramatically improved, thus reducing overall costs to produce a loan for the lender. NAFCU concurs with the SBA's belief that the introduction of the business credit scoring option would increase the volume of smaller loans that credit unions originate and reduce the costs associated with making these loans, without jeopardizing their credit quality.

Despite the benefits that credit scoring might provide when utilized by traditional depository lenders, NAFCU is concerned about the lack of guardrails associated with the proposed use of business credit scoring models. The proposed rule states that "SBA anticipates that credit scoring models will primarily be used for small loans. SBA anticipates that the higher an applicant's requested loan amount is, the more likely it will be that a Lender or CDC will conduct more traditional underwriting."[5] Although NAFCU appreciates the SBA's decision to err toward flexibility in the ability to use a business credit scoring model, this alternative, just as with the loosening of other underwriting standards, is ripe for abuse by non-depository lenders who lack a prudential regulator.

Credit unions, as previously noted, are regulated by the NCUA and subject to supervision and examination. Under Section 723.1(c)(2) credit unions are permitted to make commercial loans under the terms and conditions of a government program that secures the loans with insurance or a guarantee, [6] such as the SBA loan programs, however they must maintain credit risk management practices that are commensurate with the level of complexity and nature of their lending activities. Credit unions would therefore avoid utilizing a business credit scoring model for larger, more complex commercial loans. Fintechs on the other hand, undergo no such supervision or examinations and have little incentive to implement more traditional, costlier underwriting when originating larger loans. In fact, the opposite has been shown to be true, with

[4] Treasury, "Assessing the Impact of New Entrant Non-bank Firms on Competition in Consumer Finance Markets" (November, 2022) available at https://home.treasury.gov/system/files/136/Assessing-the-Impact-of-New-Entrant-Nonbank-Firms.pdf
[5] *See* 87 FR 64724.
[6] *See* 12 CFR Part 723.

fintechs using automated technology to underwrite and screen for fraud in PPP lending, with disastrous results.[7] While fiscally prudent institutions such as credit unions have the incentives and regulatory framework necessary to appropriately scale the use of business credit scoring models, fintechs have shown themselves to be too profit-driven and inexperienced to responsibly utilize this option. Therefore, the SBA should place a loan dollar limit on the use of business credit scoring models and limit their use to those loans below the threshold.

Hazard Insurance

The Affiliation Proposed Rule would also remove the requirement that all 7(a) and 504 loans require hazard insurance on collateral and instead only require hazard insurance for loans greater than $150,000. Although NAFCU appreciates the SBA's effort to reduce burdens associated with smaller loans, in practice, most credit unions would take a conservative approach and continue to maintain hazard insurance for all loans in which the credit union takes collateral. In light of this and the simultaneous rulemaking in the SBLC Proposed Rule, NAFCU is concerned that non-depository institutions that engage in 7(a) lending through an SBLC license would be unlikely to take the same conservative approach and might expose the loan program to additional risk.

Reconsideration After Denial

Current regulation gives the Director of the Office of Financial Assistance the ability to make final reconsideration of denial of a loan application or loan modification request in the 7(a) and 504 Loan Programs. The Affiliation Proposed Rule would expand the number of individuals able to make this reconsideration to the Director's designee or the Administrator of the SBA. Although NAFCU supports the potential for flexibility that would be created by allowing the Director to appoint a designee, NAFCU sees no reason why the politically-appointed Administrator of the SBA should become involved in a decision-making process traditionally carried out by career government officials. Including the Administrator in this process could tarnish the patina of impartiality in government lending and should not be included in the final rule.

Size Standards and Affiliation Principles

NAFCU supports the SBA's proposed revision of its affiliation provisions to simplify the program requirements, streamline the application process for the SBA's programs, and facilitate the review of such applications. The success of temporary affiliation streamlining as a result of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provides a useful test case and demonstrates that the current affiliation provisions are unnecessarily burdensome and can safely be simplified. The SBA's decision to remove the principle of control in determining affiliation in

[7] *See* Select Subcommittee on the Coronavirus Crisis, "'We are not the fraud police' How fintechs facilitated fraud in the paycheck protection program" (December 1, 2022) available at https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov/files/2022.12.01%20How%20Fintechs%20Facilitated%20Fraud%20in%20the%20Paycheck%20Protection%20Program.pdf

favor of an affiliation determination based on ownership is reasonable and much more practical for lenders to evaluate.

Relation to SBLC Moratorium Rescission

The Affiliation Proposed Rule cannot be evaluated in a vacuum. Regardless of the merits of the changes put forward in the proposal, each change must be evaluated using the same lens: What would the impact of this change be if applied to an unregulated fintech with little experience in government-back lending and immature and potentially insufficient compliance systems and culture of consumer protection? This is not merely a worst-case scenario or philosophical exercise; it is the very recent reality of fintech participation in Paycheck Protection Program (PPP) lending. In a damning report released this month by the Select Subcommittee on the Coronavirus Crisis, the true extent of fintech malfeasance in their role as stewards of federal dollars was laid bare, and it serves as a cautionary tale for those who would allow unregulated, untested financial institutions access to the federal government's largest guaranteed loan portfolio.

The report found, among other things, that the rate of fraud among fintech PPP loans was disproportionately high, that fintechs were aware of the fraud but did not have the capabilities to detect and respond to this fraud, that billions of taxpayer dollars were lost to fraud, and that fintechs prioritized high-dollar loans, with one fintech executive saying of smaller loan applications, "delete them …[w]e're not the first bank to decline [PPP] borrowers who deserve to be funded…they go elsewhere."[8] The purpose of the Affiliation Proposed Rule is to "encourage and facilitate more lenders to make more small dollar loans."[9] Fintechs have shown, to the detriment of deserving small businesses, that they lack the incentives and community focus to make small dollar business lending a priority. They have also shown that they lack the necessary compliance structures, processes, and regulatory oversight to ensure that they can participate in government-backed lending in a safe, responsible manner.

The Subcommittee report concludes 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."[10] The SBA should heed this recommendation and stop the Affiliation and SBLC rulemaking processes until the impacts of the rules have been fully evaluated and appropriate legislative and regulatory safeguards are introduced for non-depository lenders.

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[8] Id.

[9] *See* 87 FR 64724.

[10] *See* Select Subcommittee on the Coronavirus Crisis, "'We are not the fraud police' How fintechs facilitated fraud in the paycheck protection program" (December 1, 2022) *available at* https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov/files/2022.12.01%20How%20Fintechs%20Facilitated%20Fraud%20in%20the%20Paycheck%20Protection%20Program.pdf.

Conclusion

NAFCU appreciates the opportunity to comment on this proposed rule. NAFCU urges the SBA to rescind or pause the rulemaking process for this rule and the SBLC rule. NAFCU supports the portions of this rulemaking that provide flexibility and facilitate the origination of small-dollar commercial lending. However, the SBA should avoid the inclusion of political appointees in the lending process. If you have any questions or concerns, please do not hesitate to contact me at 703-842-2268 or jakin@nafcu.org.

Sincerely,

James Akin
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