

Taxpayers paid \$1.3B to cover bad business loans

Some borrowers defaulted before making a single payment. Operators of Quiznos, Cold Stone had most expensive defaults

By: Lynn Hulsesey and Ken McCall – April 6, 2013

Lax federal oversight dating back years allowed lenders to repeatedly make bad loans to small businesses under a government program that has cost taxpayers \$1.3 billion since 2000 on defaulted loans, a Dayton Daily News investigation found.

Some borrowers in the Small Business Administration's largest federally guaranteed loan program defaulted so quickly they paid nothing on the loan, the investigation found. Operators of national franchises like Quiznos and Cold Stone Creamery collectively received millions of dollars in loans through the program despite extensive default histories by the franchises.

"Should we say the fox got distracted and quit watching the hen house?" said Pat Newcomb, director of the Ohio Small Business Development Center at the Entrepreneur Center in Dayton.

"There were an awful lot of people who got small business loans during this period 2004 to 2007 that shouldn't have gotten them," she said. "They were a bad loan when they were made. They just got worse."

Since the beginning of 1990, lenders made more than 1 million loans guaranteed under the SBA's 7(a) program, the agency's largest, according to a Dayton Daily News analysis of SBA loan data. Excluding the 280,948 loans that are still active, more than one in five of the remaining 769,242 loans were discharged to the U.S. Treasury after they defaulted and the lender and SBA were unable to collect the money owed.

Those 168,324 charged-off loans totaled \$8.6 billion in payments to lenders by the SBA. Once discharged, there is little chance the money will be recovered by the government. According to the SBA, the U.S. Treasury's average annual recovery rates between 2010-2012 was 0.63 percent of all referred loans.

Default rates and taxpayer subsidies soared in the wake of the 2008 financial crash, the nation's worst economic crisis since the Depression. But the Dayton Daily News investigation found that practices by the SBA and lenders made the already-risky small business lending program a bigger gamble.

The Dayton Daily News found:

- SBA loans were made by lenders who sometimes relied on inflated real estate values, used lax lending standards, or didn't follow SBA requirements, according to SBA financial reports and the agency's Office of the Inspector General.

- A large chunk of the bad loans resulted from lenders providing loans to franchisees for national companies despite histories of the franchise defaulting on SBA loans. The corporate franchisor is not held financially responsible for the operator's loan failure.
- Many of the borrowers paid little on the discharged loans. More than half of the 168,324 charged-off loans failed before 20 percent of the loan was repaid. More than one in three repaid only 10 percent or less of the loan. More than 7 percent did not reduce the principal on their loan at all.
- In the nine-county Dayton region, 4,419 SBA loans were made from the beginning of 1990 through the end of February of this year. Of the closed loans — meaning those paid in full or charged-off to the U.S. Treasury — one in five ended in failure. The SBA paid \$36.4 million to the lenders for the defaults.
- Lenders had little to lose when loans went bad. Not only did the government guarantee up to 85 percent of the loan amount, the loans could also be sold on the secondary market, which further reduced lender risk.

“There were a lot of lenders that got into the SBA business and just grew it really fast. They took their eye off the ball,” said John Moshier, KeyBank's senior vice president in charge of SBA lending. “They felt like because they had the guarantee, everything was good. The government was going to take care of it.”

Red flag

Reacting to the newspaper's investigation, Newcomb said it's a huge red flag that one-third of borrowers paid 10 percent or less on the guaranteed loans that defaulted and were discharged.

Clearly those borrowers and their business plans were not thoroughly vetted by lenders, and the borrowers had “no commitment to making the lender whole,” said Newcomb, a former banker.

Steve Budd, president of CityWide Development Corp., a Dayton non-profit development organization, said, “I think it's fair to say that when a business hardly makes a payment, they probably shouldn't have gotten a loan.”

The SBA 7(a) program by definition involves more risk than a conventional loan. The program's goal is to provide capital for small businesses, including those owned by minorities and women, that have had trouble getting conventional loans. It is not meant to be a license to write bad loans.

Most borrowers repay their loans, and supporters call the government's guarantee a crucial economic development tool that helps fuel the small businesses that are viewed as the engine of the nation's economy. About 97 percent of American businesses are eligible for the loans.

“The good news is the SBA has helped lots of good businesses, particularly in the early stage of development, that have gone on to be successful and paid back their loans,” said Mike Van Buskirk, president and chief executive of the Ohio Bankers League. “The bad news is because they are in a risky area they will have, by definition, more defaults.”

One of the failed loans went to Café Boulevard in Dayton's Oregon District. The restaurant and bar, which closed last year under the name Boulevard Haus, received a

\$50,000 SBA loan in December 2006 from Capital One National Association. The owner, Eva Brcic-Christian, who last May was sentenced to prison for nine years on charges stemming from insurance fraud involving another restaurant, managed to pay back less than \$9,000 of the loan, according to SBA data. After collection of collateral, the SBA had to pay Capital One \$20,755 for the default.

The SBA sets the rules for the 7(a) loans made by lenders but gives lenders great freedom in determining whether the borrower is credit-worthy and what will be counted as collateral. Most loans are approved with zero SBA oversight under the preferred lender program designed to streamline the lending process. Currently, the SBA portfolio for all its loan programs totals \$103 billion.

In its 2010 financial report, the SBA acknowledged an increase in the number of bad loans. The report said between the fiscal years of 2005-2008, lenders used overvalued real estate as collateral. The losses were “magnified because of looser underwriting procedures and credit standards by lenders prevalent in that time period,” the report says.

By fiscal year 2010, the default rate on 7(a) loans increased to 5.59 percent of the active unpaid balance — up from 1.38 percent in 2005, the first year in the decade that a taxpayer subsidy for defaults was not needed, according to SBA records. The 2012 default rate was 2.38 percent according to SBA data.

Over time, the percentage of loans that go bad is comparable to conventional lenders, said Jeanne Hulit, associate administrator for the SBA Office of Capital Access. “I compare SBA to a large bank in which inherently there is some measure of risk involved with lending but, overall, the agency provides a good bang for the taxpayers buck,” Hulit said.

The increased default rates that followed the 2008 financial collapse cost the government billions of dollars. Between fiscal year 2009 and fiscal year 2012, the SBA purchased \$14.9 billion of guaranteed defaulted loans from lenders, according to SBA annual financial reports. By comparison, the SBA purchased about \$2.5 billion in guaranteed loans in the four years between 2004 and 2007.

Newcomb, who works with entrepreneurs on their development plans, said lenders and the SBA did no one any favors by making loans to people who were not prepared to run a business. “The most heart-breaking thing I see is when someone comes to me having put \$50,000 worth of life savings and retirement into an enterprise and without any forethought,” she said. “And now they want me to bail them out. They’ve made so many mistakes, there is such a deficit now that I can’t fix it.”

Cold Stone

Lenders say loans go bad for a variety of reasons, both financial and personal. At the Cold Stone Creamery at The Greene in Beavercreek, it was a combination of the economy and high rent, said co-owner Peter Samborsky.

He and two partners in BKP Enterprise LLC opened the ice cream shop in 2006 using two SBA 7(a) loans totaling \$401,500 from Banco Popular North America of New York.

By 2011, \$277,661 of the loans were in default and the SBA purchased the bad loans from the bank under the federal guarantee.

The SBA eventually discharged \$176,538 to the Treasury for collection.

“It was a decision of looking at expenses, and if we wanted to continue operating we had to reduce the expenses,” said Samborsky. “The landlord wasn’t willing to reduce rent. And if we didn’t pay rent we’d get kicked out. So the bank is the one that unfortunately takes the hit.”

Subway and Quiznos

Franchises are major consumers of SBA loans, according to the Daily News analysis — and sub sandwich franchises top the list.

Subway and Quiznos franchises dominated the list of businesses borrowing the government guaranteed loans. Subway franchises took out at least 4,649 of the 7(a) loans since the beginning of 1990, the data show, while Quiznos took out 2,586.

But the battle of the sub shops went in drastically different directions, according to the loan data. While Subway borrowed more than 2,000 more loans than Quiznos, its loan failure rate was about one-fifth of Quiznos restaurants. Only 4.8 percent of Subway franchise SBA loans were charged off as of the end of February, while almost a quarter — 23.4 percent — of Quiznos franchise loans ended in failure and were discharged to the Treasury.

Quiznos also led all franchises with \$43.5 million in defaulted loan guarantees that SBA had to pay the lending banks. Cold Stone Creamery was second with \$29.6 million, followed by Days Inn with \$16.9 million and Ramada Inn with \$14.3 million.

The sub shops also dominate the nine-county Dayton region in numbers of SBA loans, but the disparity is even more stark. While Subway franchises took out more than twice as many 7(a) loans as Quiznos (35 to 16), only one Subway loan (2.9 percent) failed and was charged off compared to six (37.5 percent) of the Quiznos loans.

Nationwide, the 50 franchises that cost the SBA the most totaled more than \$411 million in discharged loans.

Corporate franchisors such as Quiznos and Subway contract with individual owners to operate the business, but some corporations take a bigger share of the profits than others. Quiznos’ cut from its operators makes it harder for them to be profitable, said Robert Purvin, chief executive officer for the American Association of Franchises and Dealers.

“My bet is lurking behind every failure there is price gouging to the franchisee,” said Purvin. “We’ve been after SBA for years to make no loans to franchisors that are bad players.”

He said the SBA is essentially subsidizing these big corporate franchisors because the loan money is often used to pay the franchise fees, royalties and sometimes payments on leases controlled by the franchisor.

Cold Stone's parent company, Kahala Franchising LLC, did not respond to requests for comment. Quiznos spokeswoman Elizabeth Sapp declined to comment directly on

Purvin's remarks. But she said the company is now under new management.

"For a time, Quiznos grew rapidly and while there are many success stories, the brand has had more closures over the past few years than we would like," Sapp said. "There are many factors that may have led to defaults — including a sharp increase in competition within our segment and decline in our national economy."

Multiple problems

The SBA Office of Inspector General identified multiple problems at the agency in its 2012 and 2013 reports. According to the reports, the SBA:

- Vastly understated the rate at which it made improper payments on 7(a) loan approvals and purchase of defaulted loans;
- Made \$869 million in "inappropriate or unsupported loan approvals" under the 2009 American Recovery and Reinvestment Act, otherwise known as the stimulus program; and
- Improperly paid on loan guarantees despite lender errors that didn't meet SBA requirements.

The OIG recommended the agency strengthen oversight of lenders, reduce financial losses from loan agent fraud by improving tracking and enforcement, and improve efforts to recover improper payments.

Hulit said the agency has implemented quality assurance programs, improved training and is working with the OIG to implement the recommendations for improvements.

Critics say the defaults and other problems show the SBA and lenders are not good stewards of the program. Some argue that the government should not be in the business of backing loans to small businesses and subsidizing lenders.

"Many small business owners see this as an unnecessary program of government intrusion, of picking winners and losers," said Roger Geiger, Ohio chapter executive director of the National Federation of Independent Business. "They most certainly wonder how equitable it is when it's their tax dollars being used to fund what could potentially be a competing business."

The libertarian Cato Institute in 2011 called for abolishing the SBA and said the loan program gives politicians a chance to brag about helping small businesses. Tad DeHaven, budget analyst for Cato, questioned the value of providing small business loans for low-paying jobs at gas stations and sub shops.

"One, a lot of these businesses will fail, and that is therefore wasted capital," said DeHaven. "(And) the banks love this program. It's basically free money for them."

Depending on the loan program, the SBA guarantees can be as high as 100 percent but those in 7(a) typically are 75 percent or 85 percent. When the loan defaults, the SBA purchases the guaranteed portion of the loan from the lender while the lender and SBA

try to collect what they can. Then the SBA turns the remaining unpaid portion over to Treasury for continued collection efforts.

Treasury officials can garnish wages or federal payments, withhold tax refunds, take all but \$750 a month in Social Security and send collection agencies after the borrower. But Treasury officials say collection efforts are hindered if the borrower is a limited liability company or some other corporate entity that dies when the business fails.

“It is difficult,” said Ronda Kent, assistant deputy commissioner of debt management services for the U.S. Treasury bureau of fiscal services. “These are debtors who have not paid timely and other people have foreclosed on their collateral, if that was available.”

A new corner

SBA officials contend they’ve turned a corner — with purchases of defaulted guaranteed loans declining to \$2.6 billion in fiscal 2012 from \$3.4 billion the prior year, according to the agency’s fiscal 2012 financial report. The report says the loan volumes are rising and the risk portfolio is decreasing as a greater proportion of the portfolio is for loans approved since 2009.

“All key metrics on our loan portfolio have been improving, including the percentage of loans that are in a deferred, past due, delinquent and liquidation status,” Hult said. “Generally, if the economy improves, future subsidy costs may be reduced as the corresponding default risk is reduced.”

The SBA and Federal Deposit Insurance Corp. jointly monitor lenders and Hult said 150 were removed from the SBA program between fall 2008 and June 2012.

New SBA loans to Quiznos and Cold Stone Creamery tailed off drastically since 2009, the newspaper’s analysis found.

Quiznos franchises reached a high of 626 SBA 7(a) loans in 2004, but those have fallen every year since. In 2012, Quiznos franchises received only five SBA loans. The same is true for Cold Stone Creamery franchises, which received only two SBA loans last year.

Subway, by contrast, has tapered off somewhat, but still received 173 SBA loans last year.

“Over the last four years, SBA supported more than \$106 billion in lending to more than 193,000 small businesses and entrepreneurs,” said Emily Cain, SBA spokeswoman. “And today we are using our streamlined lending programs and products to get capital to communities that are still struggling and to fill market gaps, and we are continuing to expand access to our loan programs.”

Path forward

Ultimately bad loans not only cost taxpayers but also the borrowers and lenders who pay fees based on projected losses. There has been talk of raising those fees to ensure the program is self-sustaining, but Craig Street, director of SBA lending for Huntington National Bank, said that could make the loans too expensive.

Street is a huge backer of the program because he said the guarantee provides banks with

a comfort level to invest in promising companies that are good risks even though their balance sheets don't meet conventional lending standards.

KeyBank's Moshier said avoiding the mistakes of the past involves getting back to basics: good solid underwriting and understanding risk.

"I don't care if it is SBA lending, conventional lending, mortgage lending. Slow and steady wins the race," Moshier said. "You live another day. It doesn't mean you are not making loans. You are not making stupid loans."