

Issue Update

Prior to April 2023, the Small Business Administration (SBA) capped at 14 the number of nondepository institutions – known as “small business lending companies” (SBLCs) licensed to make loans under SBA’s section 7(a) program. But in April, SBA lifted the moratorium, and in a separate rule also issued that month, amended various regulations governing the 7(a) program, including loosening underwriting standards for these loans. Since 2023, SBA has granted licenses to six new SBLCs to participate in the 7(a) program, despite stating in 2022 that the agency had the resources to supervise only three new nonbank entrants to the program. Available data indicate that the program has experienced increased defaults since those changes went into effect, particularly in loans originated by nonbank lenders.

Why It Matters

Members of Congress and other stakeholders have expressed concern that increased 7(a) loan defaults could jeopardize the ongoing viability of the 7(a) program, which is intended to operate at a “zero subsidy rate” – i.e., to generate sufficient revenue through fee collections and recoveries of collateral on defaulted loans to not require an appropriation from Congress. When SBA lifted the moratorium in 2023, the agency also loosened underwriting standards for 7(a) loans. Specifically, SBA replaced its nine-factor underwriting test with a requirement that lenders use the same underwriting that the lender uses for its “similarly-sized, non-SBA guaranteed commercial loans” or use a “business credit scoring model.” One month later, SBA through a procedural notice imposed stronger underwriting criteria for 7(a) loans greater than \$500,000 – i.e., criteria that are similar, but not identical, to the nine-factor test that SBA had removed – but maintained the looser criteria for loans of \$500,000 or below. Nonbank 7(a) lenders are not subject to Federal prudential supervision. Therefore, they are not supervised to ensure compliance with BSA/AML laws, concentration caps, safety and soundness standards, and other regulations that promote prudent lending.

The addition of six non-federally supervised SBLCs joining the 7(a) program, coupled with the looser underwriting standard, has contributed to rising default rates. Data compiled by Lumos Technologies, a financial technology firm that advises SBA lenders, show that 7(a) loans originated by nonbank lenders in 2023 had a default rate of 8.1% in 2024 – more than double the default rate of 7(a) loans originated by banks in 2023. These data are deeply concerning and strongly suggest that SBA should return to the more robust nine-factor lending criteria for underwriting 7(a) loans that had been in place prior to 2023.

Recommended Action Items

To promote safe and sound 7(a) lending, ABA recommends that SBA:

- **Reinstate the nine-factor lending criteria for underwriting 7(a) loans.**
- **Focus on increasing the number of highly regulated banks that participate in the 7(a) program instead of seeking new nonbank entrants to the program.** SBA should not grant any new SBLC licenses unless and until the agency demonstrates there is a small business lending “desert” that a new SBLC would serve and that SBA has the resources to oversee the new SBLC.
- **Resume publication of the franchise directory.** When SBA altered its rules regarding loans to franchises in April 2023, it discontinued the franchise directory, which had assisted 7(a) lenders with determining the

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eligibility of a franchisee for a 7(a) loan. The onus on checking affiliated business status now rests on the lender, increasing the cost of delivering capital to small businesses. SBA should continue to conduct eligibility reviews of franchisees and publish the franchise directory regularly.

- **Reinstate the Loan Authorization as a required document for 7(a) loans.** In the April 2023 final rule, SBA removed the Loan Authorization as a required document for 7(a) loans. The Loan Authorization had reflected SBA's commitment to guarantee the loan if specified conditions are met. The loan term length, rate, amount, and allowable uses of loan proceeds will vary from one 7(a) loan to the next. The Loan Authorization removed any uncertainty about those conditions. This was particularly important if the lender who made the loan left the financial institution or if a party sought to make modifications to the loan after origination.
- **Require start-up companies seeking a 7(a) loan to provide a minimum injection of equity.** Prior to January 2024, SBA required 7(a) borrowers to provide a 10% equity injection when the borrower is a startup (fewer than two years of business operations) or when the borrower is purchasing an existing business. This requirement better ensured the start-up company has the ability to repay the loan.
- **Cease conducting eligibility checks on 7(a) loans made by lenders in SBA's Preferred Lender Program (PLP).** Lenders who demonstrate a record of successfully processing and servicing SBA loans may qualify for PLP status, which gives the lender the final credit decision on making SBA loans under what is known as "delegated authority." In August 2023, SBA began checking the eligibility of 7(a) loan recipients of loans made by PLP lenders, despite a lack of evidence that PLP lenders are making fraudulent loans. This unnecessarily delays the receipt of 7(a) loan funds by borrowers, which may lead the borrower to look to less regulated, higher cost lenders.