



Insight

Operationalizing Small Business Emergency Loan Relief – Updated

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Executive Summary

- The Coronavirus Aid, Relief, and Economic Security (CARES) Act directs an additional \$349 billion to the Small Business Administration (SBA) for the relief of small businesses.
- There is a clearly articulated need for this aid to be delivered swiftly, but from an operational standpoint, responding to this need represents an enormous step up from the SBA's normal workflow in a very short amount of time.
- While an interim final rule offers more direction on how the new inbuilt loan forgiveness will operate, it is still not clear how the SBA will disburse such a significant sum to a significant number of lenders.

Introduction

In the face of the economic and social disruption caused by the coronavirus, Congress has now enacted three stimulus packages. With an estimated [\\$2 trillion](#) price tag, [the third package](#), the Coronavirus Aid, Relief, and Economic Security (CARES) Act, is perhaps the largest and most significant stimulus package in U.S. history.

The CARES Act sets aside \$349 billion for the relief of small businesses, to be administered by the Small Business Administration (SBA). [Small businesses](#) employ 58.9 million Americans and contributed \$5.9 trillion to GDP in 2014, the last year this information was available.

While Congress deserves recognition for the passing of such an ambitious bill, that the bill was signed into law does not somehow instantaneously distribute this \$349 billion to the businesses that need it the most; as small businesses around the country are already collapsing, targeted relief is needed immediately. Considering this urgent need, this piece aims to set out the role of the SBA, the small business relief provided under the CARES Act, the mechanism of loan forgiveness under the CARES Act, and potential implementation challenges. The SBA issued an [interim final rule](#) (IFR) providing some clarification on April 2, one day before the start of application acceptance.

The Small Business Administration (SBA)

The SBA was formed in 1953 as a byproduct of the implementation of the [Small Business Act](#) by President Eisenhower. The SBA provides a number of different programs supporting small businesses, most notably loan guaranty programs but also direct disaster loan programs. SBA-guaranteed loans are made through commercial lenders, approved to work with the SBA, to whom the agency provides a government guarantee on the loan.

Within the SBA loan guaranty program, the key tool is the 7(a) loan guarantee, also known as “7(a) loans,” so-called because it derives from section 7(a) of the Small Business Act. Loans are partially guaranteed by the SBA up to 85 percent for loans of less than \$150,000 and 75 percent for loans above this amount. The SBA's

maximum guarantee cannot exceed \$3.75 million, 75 percent of \$5 million.

Proceeds from a 7(a) loan must be used by a borrower within defined categories, most relating to property, plant, and equipment. These categories include, for example, the acquisition of land, the construction of buildings, and refinancing leases.

7(a) loans must be for the shortest possible duration, up to a maximum of 10 years. Lenders are entitled to fees and a reasonable interest rate. The Congressional Research Service [notes](#) that “In FY2019, the SBA approved 51,907 7(a) loans to 46,111 small businesses totaling \$23.2 billion. In FY2019, there were 1,708 active lending partners providing 7(a) loans.”

Within the SBA disaster loan program is a subset of economic injury disaster loans (EIDL). To be eligible for an EIDL loan, an applicant must meet the SBA’s size criteria (broadly, fewer than 500 employees) and not have credit available elsewhere. Certain other businesses are necessarily ineligible, including businesses that are predominantly legal gambling, casinos and racetracks, religious groups, and political and lobbying groups.

Successful applicants may receive up to \$2 million that may go toward fixed debts, accounts payable, and payroll. This statutory maximum may be waived where the business is a “[major source of employment](#).” In order to receive EIDL assistance, a state or governor must make a request of the President or the SBA Administrator.

The SBA holds available about \$1.1 billion in disaster loan credit subsidy to support between \$7 billion and \$8 billion in disaster loans. Historically [roughly 80 percent](#) of EIDL loans have been extended to individuals, not businesses. The SBA’s EIDL program received significant criticism in the wake of the Gulf Coast hurricanes of 2005 and 2008, and Congress created three expedited EIDL programs with short-term access to funds. The SBA, however, has made only limited use of these facilities.

Small Business Relief Under the CARES Act

Enhancements to Current Programs

The first title of the CARES Act, “Title 1 – Keeping American Workers Employed and Paid Act,” sets aside \$349 billion for the relief of small businesses. This relief is predominantly provided in the form of enhancements to the existing SBA 7(a) loan program and an expansion of the EIDL program.

The CARES Act makes substantial adjustment to the administration of the 7(a) loan program, most notably by expanding the limit such that any loan may be a maximum of \$10 million. The government guarantee is expanded to 100 percent of the loan. Loan amounts are tailored to the intended borrower, based on a calculation where the amount is the lesser of two months’ average payroll expenses plus 25 percent or \$10 million. Any borrower must make a good faith certification that they intend to maintain their payroll.

The IFR sets the maturity of 7(a) loans as only two years and allows lenders to apply an interest rate of one percent, an interest rate designed to attract the interest of lenders relative to the cost of funding for comparable maturities.

In addition, the CARES Act expands the permissible use of 7(a) proceeds to include payroll support, employee salaries, mortgage payments, rent, utilities, and any other debt obligations incurred before the covered period.

7(a) loans can now be refinanced, and the SBA Administrator is directed to reimburse lenders.

The CARES Act provides an additional \$10 billion to support the EIDL program and a further \$20 million in administrative expenses in anticipation of the increased burden to fall on the SBA. The Act also waives the SBA requirement that borrowers not be able to obtain loan forgiveness elsewhere, and in recognition of program failures in 2005 and 2008 authorizes the SBA Administrator to provide up to \$10,000 to borrowers within three days of an EIDL application.

Loan Forgiveness under the CARES Act

Perhaps the most significant implication of the CARES Act (other than the \$349 billion newly available to the program) is the codification of SBA loan forgiveness. Loan forgiveness of all categories of SBA loan assistance pre-existed the CARES Act but were **uncommon**. Under the CARES Act, borrowers become eligible for loan forgiveness to the sum of payroll, mortgage interest, rent, or utility payment costs, where the loan forgiveness amount can be as high as the original principal. Only up to 25 percent of the non-payroll costs listed can be in the forgivable amount, however. Another potential deduction from the loan forgiveness amount is found in the requirement that the loan forgiveness amount be reduced by any reduction of payroll by the borrower during the covered period.

Potential borrowers are instructed to submit to their lenders an application for loan forgiveness containing all relevant payroll and covered expenses information. Lenders have up to 60 days to calculate the loan forgiveness amount and provide borrowers a decision on their application. Lenders then have two methods by which to receive assistance from the SBA. Under the first method, the SBA must remit the loan forgiveness amount to the lender within 90 days of the lender's application decision. Under the second method, lenders may pre-empt this process by providing the SBA with a report detailing the expected forgiveness amount on a covered loan or pool of covered loans in the seventh week of the eight-week loan period. The SBA is required to provide the lender the loan forgiveness amount within 15 days of receiving this report.

Regulatory Implications

The CARES Act instructed the SBA Administrator to provide guidance and regulations implementing the loan forgiveness program within 30 days of the bill becoming law. Additionally, it granted the administrator the "Emergency Rulemaking Authority" to implement relevant regulations for all of Title 1's programs within 15 days without having to undergo the typical notice-and-comment requirements of the Administrative Procedure Act (APA). This expedited process was necessary given A) the time-sensitive nature of responding to the crisis and B) the ambiguity in establishing proper controls on the updated program. The regulations were issued in an IFR on April 2, and it is likely further guidance will follow.

Given the number of firms that are facing dire calamity in the face of this situation, there was a need for prompt clarity in order for them to receive funding in a timely manner. Under the usual rulemaking procedure, this promptness would have been impossible. By way of example, take a recent, relatively non-significant **rulemaking** from the SBA that just so happens to also involve the 7(a) process. That rule first started development in the fall of 2018, following its authorizing legislation earlier that summer. The proposed version of the rule did not come out until **June 2019**. The final version hit the books roughly two weeks ago on March 16, 2020. Firms facing this existential threat did not have one and a half years to wait for the essential details.

The details here are important, especially in how borrowers apply for loans and lenders subsequently apply for forgiveness. The borrower must certify that “the documentation presented is true and correct.” Assuming that certification is given, however, the CARES Act shields the lender from typical enforcement action under relevant [statutes](#) due to a “hold harmless” provision. This provision was likely included to reduce lender liability and thus incentivize them to process more loans. It does, however, effectively shift the validation burden to the borrowers. These borrowers, many of whom that could be relatively unfamiliar with the process, needed clear guidelines and rules spelling out what the SBA expects of their applications. The IFR helps explain some of the terms and conditions of the CARES Act loans, but many, if not most, businesses will still have questions based on their individual circumstances.

Implementation Challenges

The unprecedented size of the relief and speed at which it must be deployed to save jobs would be a challenge for even the largest agency. But the SBA is tiny by the standards of other cabinet agencies. It had less than [4,000](#) full-time equivalent employees in fiscal year (FY) 2019; in comparison, the Department of Commerce had about 52,000 for the same year, according to its FY 2020 budget [request](#).

The SBA’s capacity presents a major potential implementation challenge. Across its lending platforms, SBA approved [\\$28.2 billion](#) in loans in FY 2019 – 8 percent of what it is being asked to distribute in short order. In order to overcome these challenges, the process will have to be streamlined to an extraordinary degree. In addition, the agency’s [budget request for 2020](#) was \$820 million, of which less than half would support direct lending assistance. \$349 billion effectively equals is roughly *one thousand times* the usual annual guaranty amount, delivered in only two months.

The CARES Act requires certain documentation from businesses in order to apply. These documents include payroll records, mortgage or rent information, and “any other information the [SBA] Administrator deems necessary.” In order to facilitate the large quantity of expected loans, the SBA needed to establish very concise criteria. The IFR provides examples of the information substitutes, such as bank records in lieu of tax records, that will be helpful to applicants – though some confusion will likely persist.

As drafted, the CARES Act does not provide much guidance on how the information flowing from borrower to lender to SBA should be verified and validated. A strict interpretation of the Act implied that significant portions of the usual underwriting process should be taken on good faith, with what little testing that the Act requires (for instance, that a business seeking relief be in operation on February 15, 2020) placed the burden of verification on lenders. The IFR goes some way toward clarifying this position: The loan underwriting procedure for banks need not be any more extensive than confirming receipt of information and following the basic know-your-client requirements of the Bank Secrecy Act that seek to prevent financial crime. In addition, the IFR notes that the SBA will hold harmless any lender that demonstrates it relied on information provided by the borrower. Where a lender has received a borrower attestation, the SBA will not take an enforcement action or impose penalties against the lender. It seems likely, however, that banks will prefer to work with the customers they are familiar with before they take on entirely new customers. In an additional effort to encourage lenders to participate in the program, the IFR allows SBA guarantees to be sold on the secondary market and will not charge a fee if lenders choose to do so.

Once the lender has the required information, it needs to submit the loan to the SBA. The current online platform’s bandwidth will likely be taxed by the sheer volume of loans made. The loan submission process is also time consuming, considering the expected volume. Finally, the SBA will have to figure out how to get the money appropriated by Congress out the door to pay lenders for the forgiven portion of loans in as seamless a

fashion as possible to keep up with anticipated demand.

Conclusion

Treasury Secretary Steve Mnuchin was steadfast that the small business relief program would be ready by April 3. The SBA issued an IFR less than 24 hours ahead of the deadline, leaving little time for both borrowers and lenders to fully understand the details. Among the important elements explained in the IFR are: the information applicants will need to provide, how lenders will submit the loan details to the SBA, and how the SBA will repay the forgiven portions of loans. How smoothly the last two elements will go is complicated by the SBA's limited capacity. It remains to be seen whether the IFR and further guidance have streamlined the process enough to enable the SBA to be able to handle these significant challenges.