

Congress of the United States

House of Representatives

107th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6515

April 12, 2001

The Honorable Jim Nussle
Chairman
Committee on the Budget
309 Cannon House Office Building
Washington, DC 20515

Dear Chairman Nussle:

As members of the Committee on Small Business, we want to call your attention to an issue that is under the jurisdiction of both the Small Business and the Budget Committees, and is of critical importance to our nation's small businesses. That issue is the subsidy rate for the Small Business Administration's ("SBA's") loan programs. This issue is one of our highest priorities for the 107th Congress and we hope you and your staff will pay close attention to this matter as the Budget Committee considers the FY 2002 budget.

Of particular concern to us is the subsidy rate for the 7(a) and 504 loan programs. As you may know, 7(a) General Business Loan Guaranty Program provides loan guarantees to eligible small businesses that have been unsuccessful in obtaining private financing on reasonable terms. The 7(a) program is the SBA's largest and most important loan program in terms of number of loans and program level supported. Since the program's inception, the SBA has made or guaranteed more than 600,000 7(a) loans totaling approximately \$80 billion. Nearly 7,000 banks and non-bank lenders are now approved to participate in the 7(a) program and the proceeds from an SBA loan may be used for virtually any business purpose.

The record of the 504 program is equally impressive. Since 1980, more than \$40 billion in fixed asset financing for over 50,000 small business concerns has been arranged by 504 lenders. This represents \$17 billion in debenture authorizations by the 504 lenders, and \$25 billion in private sector and other financing, all creating or retaining more than 600,000 jobs in communities across the United States. The 504 program is a great example of taxpayer money at work, as it truly expands both entrepreneurial opportunity and the economy.

Unfortunately, we have been unsuccessful, and year after year we find that the subsidy rate has been miscalculated. Through the current fee-rate system we are over-charging our borrowers and lenders for participating in the 7(a) program. In other words, we are unnecessarily "taxing" the small businesses that use the program. Since the inception of credit reform, we have over-charged program users by \$1 billion. We must develop a fee system that keeps the subsidy rate for the program low, while not over-charging the program participants.

The problem is not an arithmetic one. SBA's calculations are correct. Rather it is a methodological one. Specifically, the Office of Management and Budget (OMB) requires SBA to look back to 1986 and review the loan performance for that and each succeeding year on a cohort basis. Additionally, OMB requires that SBA treat each cohort year equally.

There are numerous problems with this methodology, but two are obvious. First, the average life of a 7(a) loan is less than seven years. The average life of a 504 loan is approximately 12 years. As a general rule, 7(a) loans made prior to 1994 and 504 loans made prior to 1990 are no longer on SBA's books. In addition, most loans that do default do so very soon after they are made. The net result is looking back to 1986 makes no sense. The look-back period should only reflect years that SBA has a loan on its books.

With respect to OMB's methodology of treating each cohort equally, SBA's 7(a) and 504 loan volumes vary from year to year. Loan volumes from early in the 1990s are much lower than current loan volumes. Moreover, today's loans are made with much stricter underwriting requirements and are performing much better than loans made in the early 1990s. Again, OMB's methodology fails to capture this important difference. Loan cohort years should be weighted according to loan volume when a program subsidy rate is calculated.

These issues have repeatedly been brought to the attention of OMB by the SBA, by the Small Business Committee, and by the lending industry. Yet OMB has failed to revise its subsidy rate calculation methodology.

Last year, several of the Democratic members of the Small Business Committee proposed the creation of a subsidy rate floor for the 7(a) program to address this issue. Admittedly, this is a band-aid approach but without it or a similar provision, unless OMB revises its methodology, the federal government will continue charging borrowers too much to use these programs. This is a very serious issue and we hope the Budget Committee will join the Small Business Committee in correcting the problem.

The Congressional Budget Office (CBO) has now joined the Small Business Committee and the General Accounting Office (GAO) in expressing concern over the subsidy rate for the 7(a) program. In September of 2000, the CBO published a report on credit subsidy reestimates from 1993-1999. In this document, CBO demonstrated that downward reestimates for the 7(a) program have been getting successively larger.

We are committed to maintaining the long-term stability of the 7(a) and 504 programs. Obviously, the success and stability of these programs are important to America's small businesses. A large part of that stability is setting and maintaining an appropriate subsidy rate. That is why it is so important that Congress and the SBA work to find a solution to the ongoing problems with the subsidy rate calculations for these programs.

As you know, the credit subsidy or subsidy rate for the SBA loan programs is the estimated net cost to SBA of guaranteeing these loans over the entire time period in which the loans are outstanding. This period can range up to 25 years. The Federal Credit Reform Act of 1990 requires that SBA estimate these costs for loans guaranteed after FY 1991 so that they can be included in the federal budget in the year in which the loan commitments are made. These estimates, and any subsequent reestimates, are very important because they identify for Congress the amount of new appropriations and new fees needed to achieve a specific program level.

These estimates are also important in that they are used by Congress -- specifically, by the Small Business Committee -- to determine the amount of the fees charged to the small business borrowers who participate in the 7(a) and 504 programs.

SBA bases its estimate of the credit subsidy for each program on projections of cash flows within the program -- that is, the amount of cash that SBA expects to take in and pay out during each year that the loans are outstanding. The accuracy of the subsidy rate is important to the long-term stability of the 7(a) and 504 programs. If SBA under-estimates the subsidy rate, the funds appropriated by Congress to operate these programs will be short, and permanent indefinite appropriations will automatically make up the shortfall; however, the subsidy rate on future guarantees will increase.

If SBA over-estimates the subsidy rate, and the actual subsidy rate is less, the agency will have more funds than are required to operate the programs. This means that Congress appropriated too much for the programs -- in reliance on the subsidy rate -- or the fees charged the borrowers have been set too high. Either way, general revenue receives the excess. This problem has arisen in the recent past. In its Budget Views and Estimates for the Second Session of the 106th Congress, the Small Business Committee Majority expressed concern over the increase in the subsidy rate.

This concern was based primarily on the fact that SBA's estimates for the 7(a) program's subsidy rate in FY 1997 and FY 1998 were later determined to be too high. As a result, the 7(a) program participants were being overcharged through the fee system.

Under the leadership of former Chairman Talent, the Small Business Committee has tried to better understand how the 7(a) and 504 subsidy rates are calculated and whether the rates, at any given point, are an accurate reflection of the programs' cost to the government. Since 1997, the Small Business Committee has held several oversight hearings on the subsidy rate for the 7(a) and 504 programs, and the subject has been an issue at each and every annual SBA budget hearing before the Committee for the last seven years.

In other words, the Administration's original subsidy rate calculations are consistently too high, causing the need for them to be reestimated on a regular basis. This means that either Congress has been over-funding the program, or the program participants are being over-charged.

The reestimates themselves are also disconcerting. As the CBO also stated in its September 2000 report, reestimates should give policymakers a timely, accurate indication of how a loan program is performing compared with expectations, but current reestimates are very difficult to track.

This difficulty makes it impossible for Congress to determine how the loan programs are functioning, and removes the incentive for federal agencies to get the estimate right the first time. This inability to estimate and track the subsidy rate for the 7(a) program is not just SBA's problem, it's also Congress' problem. We owe it to the taxpayers, the 7(a) lenders and the small businesses borrowers who depend on the program to get it right.

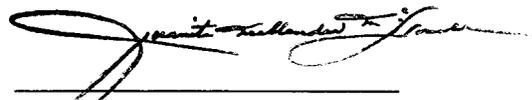
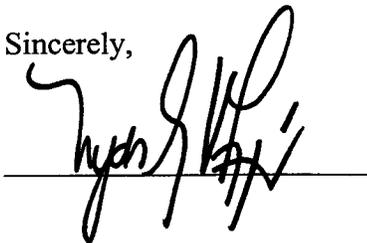
SBA is in the process of implementing a new Loan Monitoring System. It is our hope that the new Loan Monitoring System, when fully operational, will take some of the guesswork out of the subsidy rate calculations for the 7(a) program, and eventually the 504 program, and improve the accuracy of any necessary reestimates.

In the September 2000 report, CBO recommends three steps to improve the visibility and consistency of subsidy rate estimates and reestimates in the budget. These steps are: (1) Expand the Federal Credit Supplement to show both initial subsidy estimates and total reestimates by program, agency and department, with separate entries for interest reestimates and technical reestimates; (2) OMB should adopt an editing check to compare the cumulative credit subsidy reestimates reported for each fiscal year's loans in the Federal Credit Supplement, with the sum of the annual reestimates; and (3) The Analytical Perspectives volume of the budget should report all reestimates by date and program, including interest on the reestimates.

We support the changes recommended by the CBO, and we believe that these changes, coupled with the implementation of the Loan Monitoring System by the SBA, will begin to take the guesswork out of the subsidy rate calculations for the 7(a) and 504 loan programs. We urge you to join us in continuing strong congressional oversight of the subsidy rate for not only the 7(a) and 504 loan programs, but all of SBA's loan programs.

Again, congratulations on your selection as Chairman of the Budget Committee and we look forward to working with you throughout the 107th Congress.

Sincerely,



Danny L. Davis

Yvonne Christine

Erica

Grace F. Kyrle

Carbal Casado Vito

Max Udell

James Langgino

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