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SMALL BUSINESS ADMINISTRATION

7(a) Loan Program Needs Additional Performance Measures

Statement of William B. Shear, Director
Financial Markets and Community Investment

November 2007

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Highlights

Highlights of GAO-08-226T, a testimony before the Subcommittee on Federal Financial Management, Government Information, Federal Services and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The Small Business Administration's (SBA) 7(a) program, initially established in 1953, provides loan guarantees to small businesses that cannot obtain credit in the conventional lending market. In fiscal year 2006, the program assisted more than 80,000 businesses with loan guarantees of nearly $14 billion. This testimony, based on a 2007 report, discusses (1) the 7(a) program's purpose and the performance measures SBA uses to assess the program's results; (2) evidence of any market constraints that may affect small businesses' access to credit in the conventional lending market; (3) the segments of the small business lending market that were served by 7(a) loans and the segments that were served by conventional loans; and (4) 7(a) program's credit subsidy costs and the factors that may cause uncertainty about these costs.

What GAO Recommends

In the report discussed in this testimony, GAO recommended that SBA complete and expand its work on evaluating 7(a)'s performance measures and that SBA use the loan performance information it collected, such as defaults rates, to better report how small businesses fare after they participate in the program. SBA concurred with the recommendation but disagreed with one comparison in a section of the report on credit scores of small businesses with 7(a) and conventional loans. GAO believes that its analysis provides a reasonable basis for comparing these credit scores.

www.gao.gov/cgi-bin/getrpt?GAO-08-226T. To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

As the 7(a) program's underlying statutes and legislative history suggest, the loan program's purpose is intended to help small businesses obtain credit. The 7(a) program's design reflects this legislative history, but the program's performance measures provide limited information about the impact of the loans on participating small businesses. As a result, the current performance measures do not indicate how well SBA is meeting its strategic goal of helping small businesses succeed. The agency is currently undertaking efforts to develop additional, outcome-based performance measures for the 7(a) program, but agency officials said that it was not clear when they might be introduced or what they might measure.

Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections such as credit rationing, in the conventional lending market. Several studies GAO reviewed generally concluded that credit rationing was more likely to affect small businesses because lenders could face challenges in obtaining enough information on these businesses to assess their risk. However, the studies on credit rationing were limited, in part, because the literature relies on data from the early 1970s through the early 1990s, which do not account for recent trends in the small business lending market, such as the increasing use of credit scores. Though researchers have noted disparities in lending options among different races and genders, inconclusive evidence exists as to whether discrimination explains these differences.

7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. For example, from 2001 to 2004 25 percent of 7(a) loans went to small business start-ups compared to an estimated 5 percent of conventional loan. More similar percentages of 7(a) and conventional loans went to other market segments; 22 percent of 7(a) loans went to women-owned firms in comparison to an estimated 16 percent of conventional loans. The characteristics of 7(a) and conventional loans differed in several key respects: 7(a) loans typically were larger and more likely to have variable rates, longer maturities, and higher interest rates.

SBA's most recent reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 indicate that, in general, the long-term costs of these loans would be lower than initially estimated. SBA makes its best initial estimate of the 7(a) program's credit subsidy costs and revises the estimate annually as new information becomes available. In fiscal years 2005 and 2006, SBA estimated that the credit subsidy cost of the 7(a) program would be equal to zero—that is, the program would no longer require annual appropriations of budget authority—by, in part, adjusting fees paid by lenders. However, the most recent reestimates, including those made since 2005, may change because of the inherent uncertainties of forecasting subsidy costs and the influence of economic conditions such as interest rates on several factors, including loan defaults and prepayment rates.

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to be here today to discuss the Small Business Administration's (SBA) 7(a) loan program. Initially established in 1953, the 7(a) program guarantees loans made by commercial lenders—mostly banks—to small businesses for working capital and other general business purposes.[1] As the agency's largest loan program for small businesses, the 7(a) program is intended to help these businesses obtain credit that they cannot secure in the conventional lending market. For example, because they may lack the financial and other information that larger, more established firms can provide, some small businesses may be unable to obtain credit from conventional lenders. The guarantee provided through the 7(a) program assures lenders that they will receive an agreed-upon portion (generally between 50 percent and 85 percent) of the outstanding balance if a borrower defaults on a loan. Because the guarantee covers a portion of the outstanding amount, lenders and SBA share some of the risk associated with a potential default, decreasing the lender's risk and potentially making make more credit available to small businesses. In fiscal year 2006, the 7(a) program assisted slightly more than 80,000 businesses by guaranteeing loans valued at nearly $14 billion.

In my testimony, I will discuss the findings from our recent report on the SBA's 7(a) loan program.[2] Specifically, my testimony addresses (1) the 7(a) program's purpose and the performance measures SBA uses to assess the program's results; (2) evidence of any market constraints that may affect small businesses' access to credit in the conventional lending market; (3) the segments of the small business lending market that are served by 7(a) loans and the segments that are served by conventional loans; and (4) the 7(a) program's credit subsidy costs and the factors that may cause uncertainty about the 7(a) program's cost to the federal government.

In conducting this work, we reviewed the program's underlying statutes and legislative history. We compared the measures that SBA uses to assess the performance of the 7(a) program to criteria that we developed for

[1]Section 7(a) of the Small Business Act, as amended, codified at 15 U.S.C. § 636(a); see also 13 C.F.R. Part 120. Although SBA has limited legislative authority to make direct loans to borrowers that are unable to obtain loans from conventional lenders, SBA has not received any funding for these programs since fiscal year 1996.

[2]GAO, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*, GAO -07-769 (Washington, D.C: July 13, 2007).

successful performance measures and interviewed SBA officials on the agency's efforts to improve its performance measures. In addition, we summarized peer-reviewed studies on market imperfections in the lending market. Relying on SBA data from 2001 through 2004 and on the Federal Reserve's 2003 Survey of Small Business Finances (SSBF), we compared characteristics and loan terms of 7(a) borrowers to those of small business borrowers.[3] Finally, we compared SBA's original credit subsidy cost estimates for fiscal years 1992 through 2006 to SBA's current reestimates, (as reported in the fiscal year 2008 Federal Credit Supplement) and interviewed SBA officials about the differences.[4] We conducted our work in Washington, D.C., and Chicago between May 2006 and July 2007 in accordance with generally accepted government auditing standards.

In summary:

- As the 7(a) program's underlying statutes and legislative history suggest, the loan program's purpose is to help small businesses obtain credit. The 7(a) program's design reflects this legislative history, but the performance measures provide limited information about the impact of the loans on participating small businesses. The underlying statutes and legislative history of the 7(a) program help establish the federal government's role in assisting and protecting the interests of small businesses, especially those with minority ownership. The program's performance measures focus on indicators that are primarily output measures—for instance, they report on the number of loans approved and funded. But none of the measures looks at how well firms do after receiving 7(a) loans, so no information is available on outcomes. As a result, the current measures do not indicate how well the agency is meeting its strategic goal of helping small businesses succeed. The agency is currently undertaking efforts to develop additional, outcome-based performance measures for the 7(a) program, but agency officials said that it was not clear when these measures might be introduced or what they might measure.

[3]The Board of Governors of the Federal Reserve System's (Federal Reserve) SSBF is the best available data on loans made to small firms in the conventional lending market. Firms eligible for the SSBF include for-profit, nonagricultural, nondepository institutions, nongovernment businesses in operation in December 2003 and during the interview, that also had less than 500 employees. Information in the SSBF may include some loans that were guaranteed by the 7(a) loan program.

[4]Office of Management and Budget, Federal Credit Supplement, Budget of the U.S. Government, Fiscal Year 2008 (Washington, D.C.: Feb. 5, 2007).

- Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections such as credit rationing in the conventional lending market. Some studies showed, for example, that lenders might lack the information needed to distinguish between creditworthy and noncreditworthy borrowers and thus could "ration" credit by not providing loans to all creditworthy borrowers. Several studies we reviewed generally concluded that credit rationing was more likely to affect small businesses, because lenders could face challenges obtaining enough information on these businesses to assess their risk. However, the studies on credit rationing were limited because the researchers used different definitions of credit rationing and the literature relied on data from the early 1970s through the early 1990s. Data from this period does not account for recent trends in the small business lending market, such as the increasing use of credit scores, which may provide needed information and thus reduce credit rationing. Though studies we reviewed noted some disparities among borrowers with respect to race and gender in the conventional lending market, the studies did not offer conclusive evidence on the reasons for those differences.

- 7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans from 2001 to 2004. First, a higher percentage of 7(a) than conventional loans went to minority-owned and start-up businesses. For example, 28 percent of 7(a) loans compared with an estimated 9 percent of conventional loans went to minority-owned small businesses from 2001 through 2004. In addition, 25 percent of 7(a) loans went to small business start-ups, while the overall lending market served almost exclusively established firms (about 95 percent). However, more similar percentages of 7(a) and conventional loans went to other segments of the small business lending market, such as women-owned firms and those located in distressed neighborhoods. For example, 22 percent of 7(a) loans went to women-owned firms compared to an estimated 16 percent of conventional loans. Finally, the characteristics of 7(a) and conventional loans differed in several key respects. In particular, 7(a) loans typically were larger and more likely to have variable rates, longer maturities, and higher interest rates than conventional loans to small businesses.

- SBA's current reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 indicate that, in general, the long-term costs of these loans will be lower than initially estimated. Loan guarantee programs can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of the loan guarantees to the federal

government. SBA makes its best initial estimate of the 7(a) program's credit subsidy costs and revises the estimate annually as new information becomes available. Starting in fiscal year 2005, SBA estimated that the credit subsidy cost of the 7(a) program would be equal to zero—that is, the program would no longer require annual appropriations of budget authority. To offset some of the costs of the program, such as default costs, SBA adjusted a fee paid annually by lenders that are based on the outstanding portion of the guaranteed loan so that the initial credit subsidy estimates would be zero (based on expected loan performance). However, the most recent reestimates, including those made since 2005, may change. Any changes would reflect the inherent uncertainties of forecasting subsidy costs and the influence of economic conditions such as interest rates on several factors, including loan defaults (which exert the most influence over projected costs) and prepayment rates. Unemployment, which related to the condition of the national economy, could also affect the credit subsidy cost—for instance, if unemployment rises above projected levels, loan defaults are likely to increase.

- Our recent report made a recommendation to SBA that was intended to help ensure that the 7(a) program was meeting its mission responsibility of helping small firms succeed through guaranteed loans. Specifically, we recommended that SBA complete and expand its current work on evaluating the program's performance measures and use the loan performance information it already collects, including defaults and prepayment rates, to better report how small businesses fare after they participate in the 7(a) program. SBA concurred with the recommendation but has not yet told us how the agency intends to implement it.

- Finally, SBA disagreed with our analysis that showed limited differences in credit scores between small businesses that accessed credit without SBA assistance and those that received 7(a) loans. We believe that our analysis of credit scores provides a reasonable basis for comparison. As SBA noted in its comments, we disclosed the limitations of the analysis and noted the need for some caution in interpreting the results. Taking into account these limitations, we believe that future comparisons of comparable credit score data for small business borrowers may provide SBA with a more conclusive picture of the relative riskiness of 7(a) and conventional borrowers, consistent with the intent of our recommendation.

Background

To be eligible for the 7(a) loan program, a business must be an operating for-profit small firm (according to SBA's size standards) located in the United States. To determine whether a business qualifies as small for the purposes of the 7(a) program, SBA uses size standards that it has

established for each industry. SBA relies on the lenders that process and service 7(a) loans to ensure that borrowers meet the program's eligibility requirements.[5] In addition, lenders must certify that small businesses meet the "credit elsewhere" requirement. SBA does not extend credit to businesses if the financial strength of the individual owners or the firm itself is sufficient to provide or obtain all or part of the financing the firm needs or if the business can access conventional credit. To certify borrowers as having met the credit elsewhere requirement, lenders must first determine that the firm's owners are unable to provide the desired funds from their personal resources. Second, lenders must determine that the business cannot secure the desired credit for similar purposes and the same period of time on reasonable terms and conditions from nonfederal sources (lending institutions) without SBA assistance, taking into account the prevailing rates and terms in the community or locale where the firm conducts business.

According to SBA's fiscal year 2003-2008 Strategic Plan, the agency's mission is to maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters. SBA describes the 7(a) program as contributing to an agencywide goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs." As reported annually in SBA's Performance and Accountability Reports (PAR), the 7(a) program contributes to this strategic goal by fulfilling each of the following three long-term, agencywide objectives:

- increasing the positive impact of SBA assistance on the number and success of small business start-ups,
- maximizing the sustainability and growth of existing small businesses that receive SBA assistance, and

[5]Within the 7(a) program, there are several program delivery methods—regular 7(a), the certified lender program, the preferred lender program, SBAExpress, Community Express, Export Express, and Patriot Express. SBA provides final approval for loans made under the regular 7(a) program. Certified lenders must perform a thorough credit analysis on the loan application packages they submit to SBA that SBA can use to perform a credit review, shortening the loan processing time. Preferred lenders have delegated authority to make SBA-guaranteed loans, subject only to a brief eligibility review and assignment of a loan number by SBA. Lenders participating in SBAExpress, Community Express, Export Express, and Patriot Express also have delegated authority to make SBA-guaranteed loans.

- significantly increasing successful small business ownership within segments of society that face special competitive opportunity gaps.

Groups facing these special competitive opportunity gaps include those that SBA considers to own and control little productive capital and to have limited opportunities for small business ownership (such as African Americans, American Indians, Alaska Natives, Hispanics, Asians, and women) and those that are in certain rural or low-income areas. For each of its three long-term objectives, SBA collects and reports on the number of loans approved, the number of loans funded (i.e., money that was disbursed), and the number of firms assisted.

Loan guarantee programs can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of these programs—that is, the cost of the loan guarantee to the federal government. In recognizing the difficulty of estimating credit subsidy costs and acknowledging that the eventual cost of the program may deviate from initial estimates, FCRA requires agencies to make annual revisions (reestimates) of credit subsidy costs for each cohort of loans made during a given fiscal year using new information about loan performance, revised expectations for future economic conditions and loan performance, and improvements in cash flow projection methods. These reestimates represent additional costs or savings to the government and are recorded in the budget. FCRA provides that reestimates that increase subsidy costs (upward reestimates), when they occur, be funded separately with permanent indefinite budget authority.[6] In contrast, reestimates that reduce subsidy costs (downward reestimates) are credited to the Treasury and are unavailable to the agency. In addition, FCRA does not count administrative expenses against the appropriation for credit subsidy costs. Instead, administrative expenses are subject to separate appropriations and are recorded each year as they are paid, rather than as loans are originated.

[6]Permanent, indefinite budget authority is available as a result of previously enacted legislation (in this case, FCRA) and is available without further legislative action or until Congress affirmatively rescinds the authority. The amount of the budget authority is indefinite—that is, unspecified at the time of enactment—but becomes determinable at some future date (in this case, when reestimates are made).

The 7(a) Program's Policy Objectives Reflect Legislative History, but Its Performance Measures Do Not Gauge the Program's Impact on Participating Firms

The legislative basis for the 7(a) program recognizes that the conventional lending market is the principal source of financing for small businesses and that the loan assistance that SBA provides is intended to supplement rather than compete with that market. The design of the 7(a) program has SBA collaborating with the conventional market in identifying and supplying credit to small businesses in need of assistance. Specifically, we highlight three design features of the 7(a) program that help it address concerns identified in its legislative history. First, the loan guarantee, which plays the same role as collateral, limits the lender's risk in extending credit to a small firm. Second, the "credit elsewhere" requirement is intended to provide some assurance that guaranteed loans are offered only to firms that are unable to access credit on reasonable terms and conditions in the conventional lending market. Third, an active secondary market for the guaranteed portion of a 7(a) loan allows lenders to sell the guaranteed portion of the loan to investors, providing additional liquidity that lenders can use for additional loans.

Furthermore, numerous amendments to the Small Business Act and to the 7(a) program have laid the groundwork for broadening small business ownership among certain groups, including veterans, handicapped individuals, and women, as well as among persons from historically disadvantaged groups, such as African Americans, Hispanic Americans, Native Americans, and Asian Pacific Americans. The 7(a) program also includes provisions for extending financial assistance to small businesses that are located in urban or rural areas with high proportions of unemployed or low-income individuals or that are owned by low-income individuals. The program's legislative history highlights its role in, among other things, helping small businesses get started, allowing existing firms to expand, and enabling small businesses to develop foreign markets for their products and services.

All nine performance measures we reviewed provided information that related to the 7(a) loan program's core activity, which is to provide loan guarantees to small businesses. In particular, the indicators all provided the number of loans approved, loans funded, and firms assisted across the subgroups of small businesses the 7(a) program was intended to assist.

We have stated in earlier work that a clear relationship should exist between an agency's long-term strategic goals and its program's

performance measures.[7] Outcome-based goals or measures showing a program's impact on those it serves should be included in an agency's performance plan whenever possible. However, all of the 7(a) program's performance measures are primarily output measures. SBA does not collect any outcome-based information that discusses how well firms are doing after receiving a 7(a) loan. Further, none of the measures link directly to SBA's long-term objectives. As a result, the performance measures do not fully support SBA's strategic goal of increasing the success of small businesses by "bridging competitive opportunity gaps facing entrepreneurs."

SBA officials have recognized the importance of developing performance measures that better assess the 7(a) program's impact on the small firms that receive the guaranteed loans. SBA is still awaiting a final report, originally expected sometime during the summer of 2007, from the Urban Institute, which has been contracted to undertake several evaluative studies of various SBA programs, including 7(a), that provide financial assistance to small businesses.

SBA officials explained that, for several reasons, no formal decision had yet been made about how the agency might alter or enhance the current set of performance measures to provide more outcome-based information related to the 7(a) program. The reasons given included the agency's reevaluation of its current strategic plan in response to requirements in the Government Performance and Results Act of 1993 that agencies reassess their strategic plans every 3 years, a relatively new administrator who may make changes to the agency's performance measures and goals, and the cost and legal constraints associated with the Urban Institute study. However, SBA already collects information showing how firms are faring after they obtain a guaranteed loan. In particular, SBA regularly collects information on how well participating firms are meeting their loan obligations. This information generally includes, among other things, the number of firms that have defaulted on or prepaid their loans—data that could serve as reasonable proxies for determining a firm's financial status. However, the agency primarily uses the data to estimate some of the costs associated with the program and for internal reporting purposes, such as monitoring participating lenders and analyzing its current loan portfolio.

[7]Some earlier work includes GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996); and GAO, *The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans*, GAO/GGD-10.1.120 (Washington, D.C.: April 1998).

Using this information to expand its performance measures could provide SBA and others with helpful information about the financial status of firms that have been assisted by the 7(a) program.

To better ensure that the 7(a) program is meeting its mission responsibility of helping small firms succeed through guaranteed loans, we recommended in our report that SBA complete and expand its current work on evaluating the 7(a) program's performance measures. As part of this effort, we indicated that, at a minimum, SBA should further utilize the loan performance information it already collects, including but not limited to defaults, prepayments, and number of loans in good standing, to better report how small businesses fare after they participate in the 7(a) program. In its written response, SBA concurred with our recommendation.

Limited Evidence Suggests That Certain Market Imperfections May Restrict Access to Credit for Some Small Businesses

We found limited information from economic studies that credit constraints such as credit rationing could have some effect on small businesses in the conventional lending market. Credit rationing, or denying loans to creditworthy individuals and firms, generally stems from lenders' uncertainty or lack of information regarding a borrower's ability to repay debt. Economic reasoning suggests that there exists an interest rate—that is, the price of a loan—beyond which banks will not lend, even though there may be creditworthy borrowers willing to accept a higher interest rate.[8] Because the market interest rate will not climb high enough to convince lenders to grant credit to these borrowers, these applicants will be unable to access credit and will also be left out of the lending market.[9] Of the studies we identified that empirically looked for evidence of this constraint within the conventional U.S. lending market, almost all provided some evidence consistent with credit rationing. For example, one study found evidence of credit rationing across all sizes of firms.[10] However, another study suggested that the effect of credit rationing on

[8]For more details on how economic theory predicts credit rationing, see J.E. Stiglitz and A. Weiss, "Credit Rationing in Markets with Imperfect Information," *The American Economic Review*, vol. 71, no.3 (1981).

[9]However, under certain circumstances, economic reasoning suggests that lack of information about certain types of borrowers could result in the opposite—an excess of credit. See D. DeMeza and D.C. Webb, "Too Much Investment: A Problem of Asymmetric Information," *The Quarterly Journal of Economics*, vol. 102, no. 2 (1987).

[10]S. J. Perez, "Testing for Credit Rationing: An Application of Disequilibrium Econometrics," *Journal of Macroeconomics*, vol. 20, no. 4 (1998).

small firms was likely small, and another study suggested that the impact on the national economy was not likely to be significant.[11]

Because the underlying reason for having been denied credit can be difficult to determine, true credit rationing is difficult to measure. In some studies we reviewed, we found that researchers used different definitions of credit rationing, and we determined that a broader definition was more likely to yield evidence of credit rationing than a narrower definition. For example, one study defined a firm facing credit rationing if it had been denied a loan or discouraged from applying for credit.[12] However, another study pointed out that firms could be denied credit for reasons other than credit rationing—for instance, for not being creditworthy.[13] Other studies we reviewed that studied small business lending found evidence of credit rationing by testing whether the circumstances of denial were consistent with a "credit rationing" explanation such as a lack of information. Two studies concluded that having a preexisting relationship with the lender had a positive effect on the borrower's chance of obtaining a loan.[14] The empirical evidence from another study suggested that lenders used information accumulated over the duration of a financial relationship with a borrower to define loan terms.[15] This study's results suggested that firms with longer relationships received more favorable terms—for instance, they were less likely to have to provide collateral. Because having a relationship with a borrower would lead to the lender's having more information, the positive effect of a preexisting relationship is consistent with the theory behind credit rationing.

[11]A. R. Levison and Kristen L. Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S.," *Small Business Economics*, vol. 14, no. 2 (2000); and A. N. Berger and G. F. Udell, "Some Evidence on the Empirical Significance of Credit Rationing," *The Journal of Political Economy*, vol. 100, no. 5 (1992).

[12]J. Berkowitz and M. J. White, "Bankruptcy and Small Firms' Access to Credit," *The RAND Journal of Economics*, vol. 35, no. 1 (2004).

[13]Levinson and Willard, "Do Firms Get the Financing They Want?"

[14]M. A. Petersen and R. G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *The Journal of Finance*, vol. 49, no. 1 (1994); and R. A. Cole, "The Importance of Relationships to the Availability of Credit," *Journal of Banking and Finance*, vol. 22 (1998).

[15]A. N. Berger and G. F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *The Journal of Business*, vol. 68, no. 3 (1995).

However, the studies we reviewed regarding credit rationing used data from the early 1970s through the early 1990s and thus did not account for several recent trends that may have impacted, either positively or negatively, the extent of credit rationing within the small business lending market. These trends include, for example, the increasing use of credit scores, changes to bankruptcy laws, and consolidation in the banking industry.

Discrimination on the basis of race or gender may also cause lenders to deny loans to potentially creditworthy firms. Discrimination would also constitute a market imperfection, because lenders would be denying credit for reasons other than interest rate or another risk associated with the borrower. A 2003 survey of small businesses conducted by the Federal Reserve examined differences in credit use among racial groups and between genders.[16] The survey found that 48 percent of small businesses owned by African Americans and women and 52 percent of those owned by Asians had some form of credit, while 61 percent of white- and Hispanic-owned businesses had some form of credit.[17] Studies have attempted to determine whether such disparities are due to discrimination, but the evidence from the studies we reviewed was inconclusive.

A Higher Percentage of 7(a) Loans Went to Certain Segments of the Small Business Lending Market, but Conventional Loans Were Widely Available

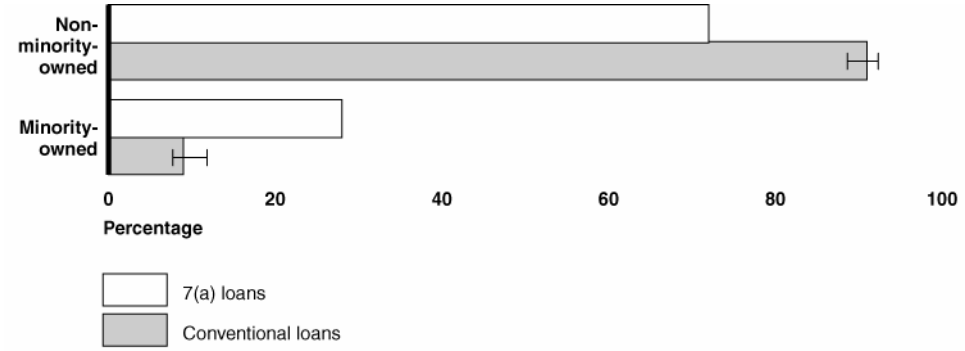
Certain segments of the small business lending market received a higher share of 7(a) loans than of conventional loans between 2001 to 2004, including minority-owned businesses and start-up firms. More than a quarter of 7(a) loans went to small businesses with minority ownership, compared with an estimated 9 percent of conventional loans (fig. 1). However, in absolute numbers many more conventional loans went to the segments of the small business lending market we could measure, including minority-owned small businesses, than loans with 7(a) guarantees.[18]

[16]T. L. Mach and J. D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin* Oct.: A167-A195 (2006).

[17]The survey question specifically asked respondents about having a credit line, loan, or capital lease.

[18]For example, we estimate that in 2004 approximately 62,000 outstanding 7(a) loans went to minority-owned firms, while there were more than 1.6 million outstanding loans to minority-owned small businesses from the conventional lending market.

Figure 1: Percentage of 7(a) and Conventional Loans by Minority Status of Ownership, 2001-2004

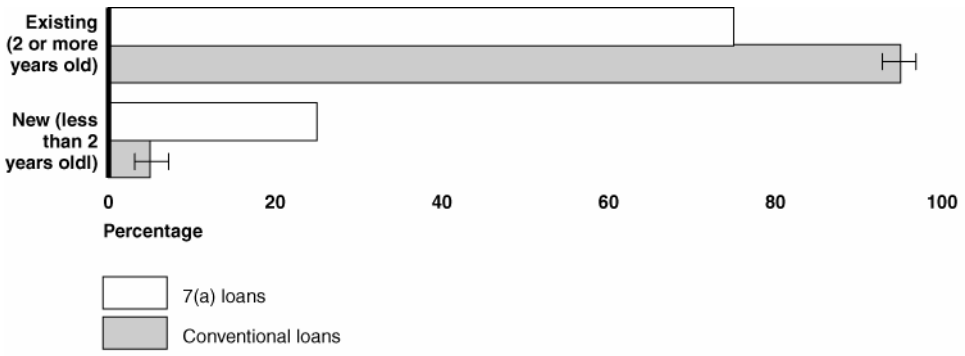


Source: GAO analysis of SBA and Federal Reserve Board of Governor's data.

Note: The brackets on the conventional loans represent confidence intervals. Because the data from SSBF are from a probability survey based on random selections, this sample is only one of a large number of samples that might have been drawn. Since each sample could have provided different estimates, we express our confidence in the precision of the particular results as a 95-percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. As a result, we are 95-percent confident that each of the confidence intervals will include the true values in the study population. Information on SBA 7(a) loans does not have confidence intervals, because we obtained data on all the loans SBA approved and disbursed from 2001 to 2004.

Compared with conventional loans, a higher percentage of 7(a) loans went to small new (that is, start-up) firms from 2001 through 2004 (fig. 2). Specifically, 25 percent of 7(a) loans went to small business start-ups, in contrast to an estimated 5 percent of conventional loans that went to newer small businesses over the same period.

Figure 2: Percentage of 7(a) and Conventional Loans by Status as a New Business, 2001-2004

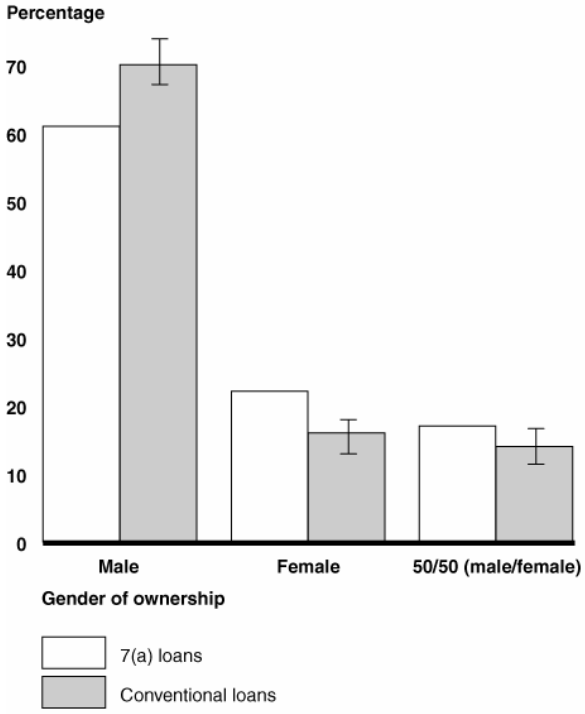


Source: GAO analysis of SBA and Federal Reserve Board of Governor's data.

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

Only limited differences exist between the shares of 7(a) and conventional loans that went to other types of small businesses from 2001 through 2004. For example, 22 percent of all 7(a) loans went to small women-owned firms, compared with an estimated 16 percent of conventional loans that went to these firms. The percentages of loans going to firms owned equally by men and women were also similar—17 percent of 7(a) loans and an estimated 14 percent of conventional loans (fig. 3). However, these percentages are small compared with those for small firms headed by men, which captured most of the small business lending market from 2001 to 2004. These small businesses received 61 percent of 7(a) loans and an estimated 70 percent of conventional loans.

Figure 3: Percentage of 7(a) and Conventional Loans by Gender of Ownership, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data.

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

Similarly, relatively equal shares of 7(a) and conventional loans reached small businesses in economically distressed neighborhoods (i.e., zip code areas) from 2001 through 2004—14 percent of 7(a) loans and an estimated 10 percent of conventional loans.[19] SBA does not specifically report whether a firm uses its 7(a) loan in an economically distressed neighborhood but does track loans that go to firms located in areas it considers "underserved" by the conventional lending market.[20] SBA's own

[19]We defined distressed neighborhoods as zip code areas where at least 20 percent of the population had incomes below the national poverty line.

[20]These include the following federally defined areas: Historically Underutilized Business Zone, Empowerment Zone/Enterprise Community, low- and moderate-income census tract (median income of census tract is no greater than 80 percent of the associated metropolitan area or nonmetropolitan median income), or rural (as classified by the U.S. Census).

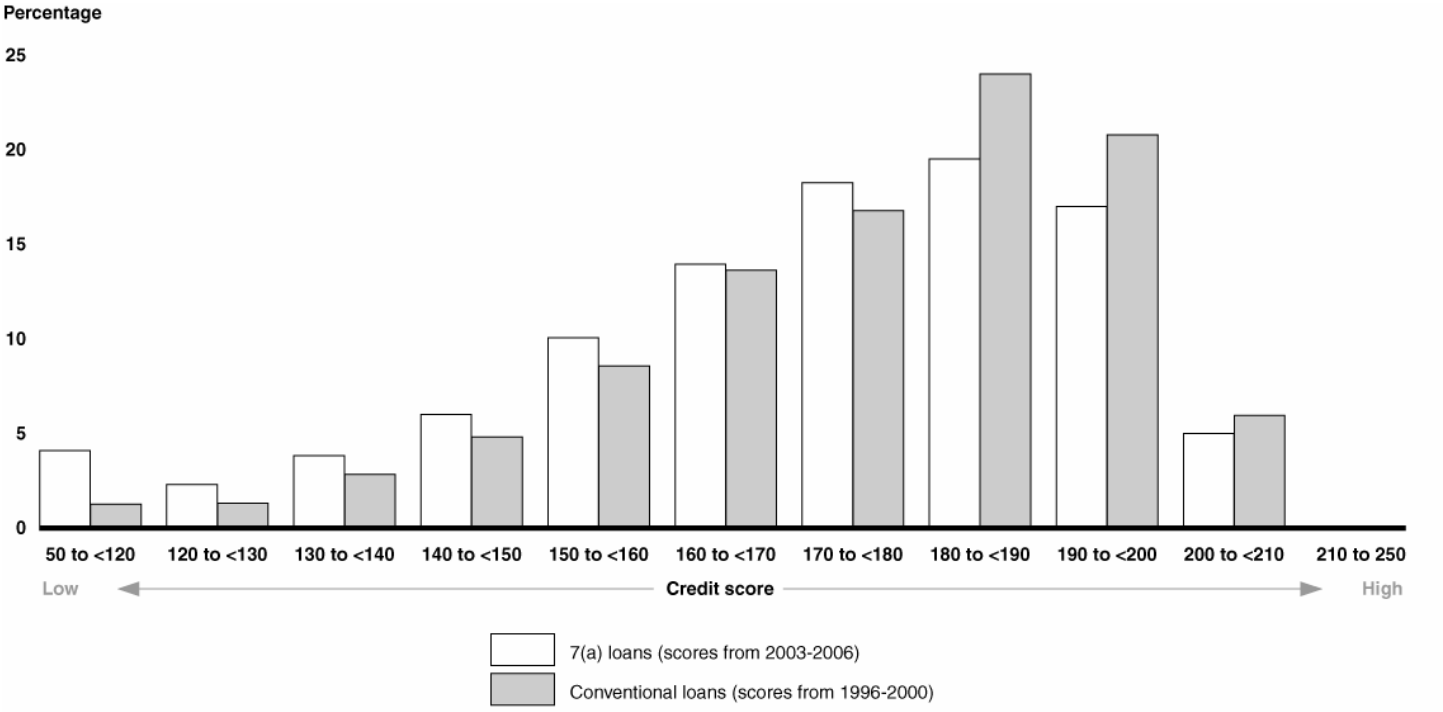
analysis found that 49 percent of 7(a) loans approved and disbursed in fiscal year 2006 went to these geographic areas.

A higher proportion of 7(a) loans (57 percent) went to smaller firms (that is, firms with up to five employees), compared with an estimated 42 percent of conventional loans. As the number of employees increased, differences in the proportions of 7(a) and conventional loans to firms with similar numbers of employees decreased. Also, similar proportions of 7(a) and conventional loans went to small businesses with different types of organizational structures and in different geographic locations.

Our analysis of information on the credit scores of small businesses that accessed credit without SBA assistance showed only limited differences between these credit scores and those of small firms that received 7(a) loans. As reported in a database developed by two private business research and information providers, The Dun & Bradstreet Corporation and Fair Isaac Corporation (D&B/FIC), the credit scores we compared are typically used to predict the likelihood that a borrower, in this case a small business, will repay a loan.[21] In our comparison of firms that received 7(a) loans and those that received conventional credit, we found that for any particular credit score band (e.g., 160 to <170) the differences were no greater than 5 percentage points. The average difference for these credit score bands was 1.7 percentage points (fig. 4). More credit scores for 7(a) borrowers were concentrated in the lowest (i.e., more risky) bands compared with general borrowers, but most firms in both the 7(a) and the D&B/FIC portfolios had credit scores in the same range (from 170 to <200). Finally, the percentage of firms that had credit scores in excess of 210 was less than 1 percent for both groups.

[21]The portfolio management score used by SBA is the Small Business Predictive Score (SBPS). The SBPS is based on consumer and business data and assigns scores to small businesses in the absolute range of 1 to 300, but the practical range of 50 to 250. A lower score generally indicates a greater likelihood of repayment risk, while a higher score indicates a greater likelihood that the loan will be repaid.

Figure 4: Percentage of Small Business Credit Scores (2003-2006) for Firms That Received 7(a) and Conventional Credit in D&B/FIC Sample (1996-2000), by Credit Score Range



Source: GAO analysis of initial credit scores for loans in the SBA portfolio (2003-2006) and D&B/FIC's analysis of credit scores from data on small businesses in the small business portfolio score (SBPS) development sample (1996-2000).

The results our analysis of credit scores should be interpreted with some caution. First, the time periods for the two sets of credit scores are different. Initial credit scores for businesses receiving 7(a) loans in our analysis are from 2003 to 2006.[22] The scores developed by D&B/FIC for small businesses receiving conventional credit are based on data from 1996 through 2000 that include information on outstanding loans that may have originated during or many years before that period.[23] Second,

[22]SBA says it first received SBPS credit scores for the outstanding 7(a) loans in its portfolio in March 2003. Since then, SBA has received an initial score, known as the Surrogate Origination Score, for a 7(a) loan 1 to 4 months after the loan is disbursed. SBA subsequently has received SBPS scores on a quarterly basis for almost all of the active loans in its portfolio. We obtained data for all 7(a) loans approved and disbursed from 2001 through 2005, so the dates of the initial credit scores ranged from 2003 to 2006.

[23]The earlier period of credit scores for firms that obtained credit in the conventional lending market represents data D&B/FIC had readily available and could provide to us.

D&B/FIC's scores for small businesses receiving conventional loans may not be representative of the population of small businesses. Although D&B/FIC combined hundreds of thousands of financial records from many lenders and various loan products with consumer credit data for their credit score development sample, they explained that the sample was not statistically representative of all small businesses.

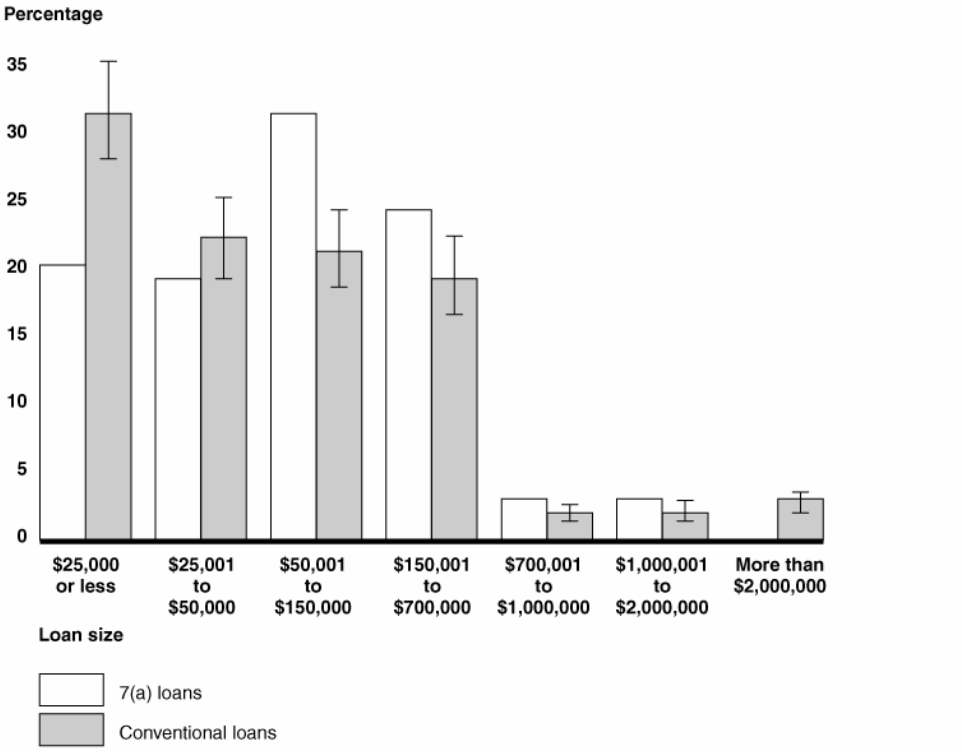
Another score developed by D&B, called the Financial Stress Score (FSS), gauges the likelihood that a firm will experience financial stress—for example, that it will go out of business.[24] SBA officials said that based on analyses of these scores, the difference in the repayment risk of lending associated with 7(a) loans was higher than the risk posed by small firms able to access credit in the conventional lending market. According to an analysis D&B performed based on these scores, 32 percent of 7(a) firms showed a moderate to high risk of ceasing operations with unpaid obligations in 2006, while only 17 percent of general small businesses had a similar risk profile.

As already mentioned, SBA disagreed with the results of our credit score comparison. In its written comments to our prior report, SBA primarily reiterated the cautions included in our report and stated that the riskiness of a portfolio was determined by the distribution in the riskier credit score categories. SBA said that it had not worked out the numbers but had concluded that the impact on loan defaults of the higher share of 7(a) loans in these categories would not be insignificant. Although SBA disagreed with our results, we believe that our analysis of credit scores provides a reasonable basis for comparison. Specifically, the data we used were derived from a very large sample of financial transactions and consumer credit data and reflected the broadest and most recent information readily available to us on small business credit scores in the conventional lending market. As SBA noted in its comments, we disclosed the data limitations and necessary cautions to interpreting the credit score comparison. Taking into consideration the limitations associated with our analysis, future comparisons of comparable credit score data for small business borrowers may provide SBA with a more conclusive picture of the relative riskiness of borrowers with 7(a) and conventional loans, which would also be consistent with the intent of our recommendation that SBA develop more outcome-based performance measures.

[24]The FSS predicts the likelihood that a business will cease operations without paying creditors in full or that will go into receivership.

We also compared some of the characteristics of 7(a) and conventional loans, including the size of the loans. In the smallest loan categories (less than $50,000), a higher percentage of total conventional loans went to small businesses—53 percent, compared with 39 percent of 7(a) loans. Conversely, a greater percentage of 7(a) loans than conventional loans were for large dollar amounts. For example, 61 percent of the number of 7(a) loans had dollar amounts in the range of more than $50,000 to $2 million (the maximum 7(a) loan amount), compared with an estimated 44 percent of conventional loans (fig. 5).

Figure 5: Percentage of 7(a) Loans and Conventional Loans by Loan Size, 2001-2004



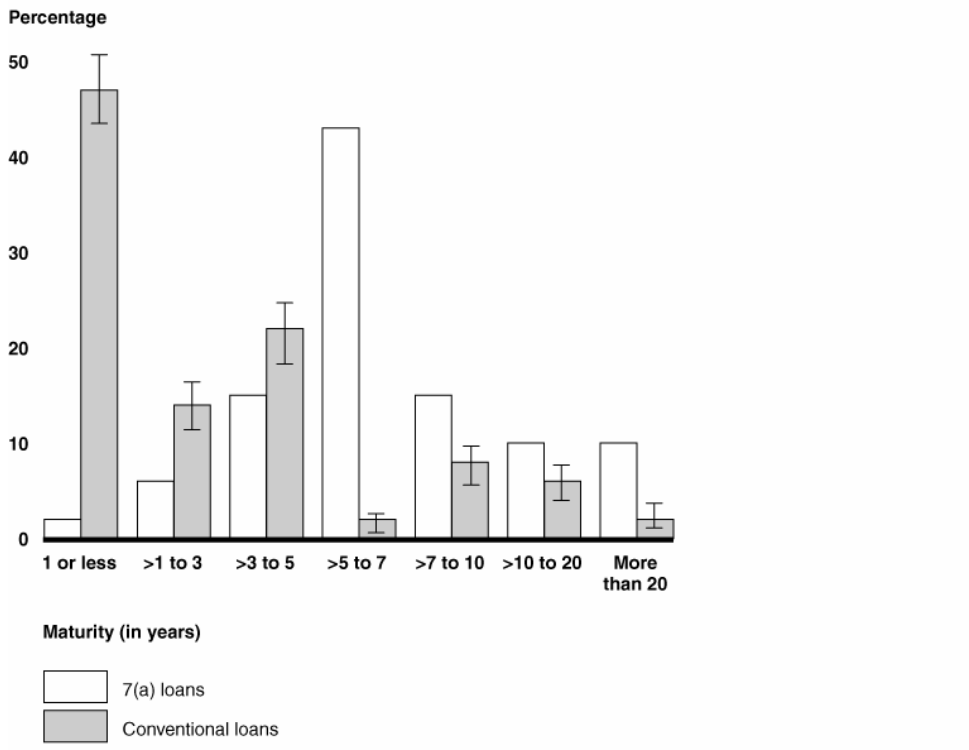
Source: GAO analysis of SBA and Federal Reserve Board of Governors' data.

Note: The brackets on the conventional loans represent a 95-percent confidence interval. The maximum gross 7(a) loan amount is $2 million. The dollar range categories on this chart reflect program thresholds for loan amounts associated with different interest rates or guarantee fee levels.

Further, almost all 7(a) loans had variable interest rates and maturities that tended to exceed those for conventional loans. Nearly 90 percent of 7(a) loans had variable rates compared with an estimated 43 percent of conventional loans, and almost 80 percent of 7(a) loans had maturities of

more than 5 years, compared with an estimated 17 percent of conventional loans (fig. 6).

Figure 6: Percentage of 7(a) and Conventional Loans by Loan Maturity Category, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data.

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

For loans under $1 million, interest rates were generally higher for 7(a) loans than for conventional loans. From 2001 through 2004, quarterly interest rates for the 7(a) program were, on average, an estimated 1.8 percentage points higher than interest rates for conventional loans (fig. 7).[25] Interest rates for small business loans offered in the conventional market tracked the prime rate closely and were, on average, an estimated

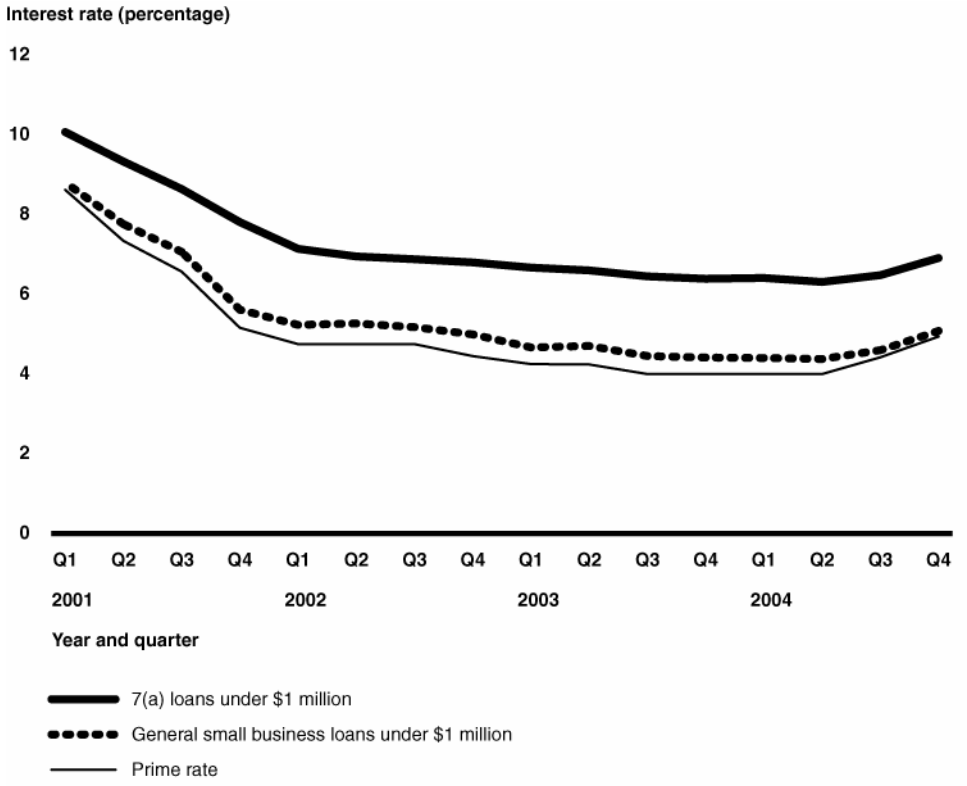
[25]We used SBA data to calculate the calendar year and quarter in which each loan was approved and to calculate interest rates for all loans in a given quarter that were for under $1 million.

0.4 percentage points higher.[26] Because the maximum interest rate allowed by the 7(a) program was the prime rate plus 2.25 percent or more, over the period the quarterly interest rate for 7(a) loans, on average, exceeded the prime rate.[27]

[26]We used the Federal Reserve's *Survey of Terms of Business Lending*, which provides information quarterly on commercial and industrial loans of loans in four size categories (less than $100,000; from $100,000 through $999,999; from $1 million through $999,999,000; and $10 million or more) made only by commercial banks. We used only data related to the first two categories because those loan amounts most resembled the 7(a) loans in the SBA data and, as discussed previously, SBA considers loans reported in call report data of $1 million or less to be for small businesses.

[27]We used the Federal Reserve's historical reports on the monthly bank prime rate to estimate the prime rate for every quarter from 2001 through 2004.

Figure 7: Interest Rate Comparison for Loans under $1 Million and Prime Rate, 2001-2004



Source: GAO's analysis of SBA data, the Federal Reserve Board of Governors' quarterly *Survey of Terms of Bank Lending* (2001 to 2004), and the Federal Reserve Board of Governors' H.15 statistical release for bank prime loan rates.

Current Reestimates Show Lower-Than-Expected Subsidy Costs, but Final Costs May be Higher or Lower for Several Reasons

The current reestimated credit subsidy costs of 7(a) loans made during fiscal years 1992 through 2004 generally are lower than the original estimates, which are made at least a year before any loans are made for a given fiscal year. Loan guarantees can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of the loan guarantees to the federal government and revise its estimates (reestimate) those costs annually as new information becomes available. The credit subsidy cost is often expressed as a percentage of loan amounts—that is, a credit subsidy rate of 1 percent indicates a subsidy cost of $1 for each $100 of loans. As we have seen, the original credit subsidy cost that SBA estimated for fiscal years 2005 and 2006 was zero, making the 7(a) program a "zero credit subsidy" program—that is, the program no longer required annual

appropriations of budget authority. For loans made in fiscal years 2005 and 2006, SBA adjusted the ongoing servicing fee that it charges participating lenders so that the initial subsidy estimate would be zero based on expected loan performance at that time. Although the federal budget recognizes costs as loans are made and adjusts them throughout the lives of the loans, the ultimate cost to taxpayers is certain only when none of the loans in a cohort remain outstanding and the agency makes a final, closing reestimate. In addition to the subsidy costs, SBA incurs administrative expenses for operating the loan guarantee program, though these costs are appropriated separately from those for the credit subsidy. In its fiscal year 2007 budget request, SBA requested nearly $80 million to cover administrative costs associated with the 7(a) program.

Any forecasts of the expected costs of a loan guarantee program such as 7(a) are subject to change, since the forecasts are unlikely to include all the changes in the factors that can influence the estimates. In part, the estimates are based on predictions about borrowers' behavior—how many borrowers will pay early or late or default on their loans and at what point in time. According to SBA officials, loan defaults are the factor that exerts the most influence on the 7(a) credit subsidy cost estimates and are themselves influenced by various economic factors, such as the prevailing interest rates. Since the 7(a) program primarily provides variable rate loans, changes in the prevailing interest rates would result in higher or lower loan payments, affecting borrowers' ability to pay and subsequently influencing default and prepayment rates. For example, if the prevailing interest rates fall, more firms could prepay their loans to take advantage of lower interest rates, resulting in fewer fees for SBA. Loan defaults could also be affected by changes in the national or a regional economy. Generally, as economic conditions worsen—for example, as unemployment rises—loan defaults increase. To the extent that SBA cannot anticipate these changes in the initial estimates, it would include them in the reestimates.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the Subcommittee may have.

Contacts and Staff Acknowledgments

For additional information about this testimony, please contact William B. Shear at (202) 512-8678 or Shearw@gao.gov. Contact points for our Offices of Congressional Affairs and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony

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