

United States Senate

WASHINGTON, DC 20510

April 22, 2002

The Honorable Mitchell Daniels
Director, Office of Management and Budget
Eisenhower Executive Office Building
17th and Pennsylvania Ave., NW
Washington, D.C. 20503

Dear Mr. Daniels:

We are writing to express our concern about what appears to be the continued and routine over-estimation by OMB of the cost of the Small Business Administration's 504 and 7(a) loan programs to the government under the requirements of the Federal Credit Reform Act (Credit Reform). The Senate has repeatedly raised this issue with the OMB, most recently in the FY 2002 appropriations cycle, at a Roundtable held by the Senate Committee on Small Business and Entrepreneurship last fall, and in meetings between Senate Budget Committee staff and OMB staff.

Last fall, the SBA Administrator publicly stated, and your senior OMB staff indicated to our staff, that the subsidy rate for the 7(a) program would be cut at least in half, all else being equal. Unfortunately, the 2003 budget request reflects that only half of that goal has been accomplished. Given the systematic mis-estimates in these programs, this progress, while in the right direction, has been too slow and does not do much to engender confidence in the Administration's approach in light of SBA or OMB mistakes in budget documents over the years.

In our view, failure to solve the problem will continue the unfair practice of forcing small business borrowers and lenders, year after year, to pay fees that are substantially higher than necessary to participate in and cover the government's cost of these programs.

The nexus of the problem appears to be the use of overly conservative loan default rates as part of each program's cost calculation under Credit Reform and the failure to adequately weight historical data to reflect more accurately the program changes, both statutory and regulatory, that have resulted in reduced default rates and improved program performance.

The FY 2003 credit subsidy rate for the 504 program assumes an 8.3 percent loan default rate. But program statistics from the Bank of New York suggest the rate is in the 4 percent range instead. Use of the higher default rate results in the average 504 borrower unnecessarily paying approximately \$10,000 in excess fees to participate in this program. We should emphasize that this program receives no federal appropriations and is totally funded through fees. Yet, since 1997 the program has paid nearly \$400 million in excess fees to the U.S. Treasury as a result of OMB re-estimates. Since 1995, the use of overly conservative default rate assumptions in the 7(a) program has resulted in total downward re-estimates of \$1.429 billion, including interest.

The SBA testified earlier this year that it is developing an econometric model to estimate more accurately the default rate for each program. But, although we have already been told for at least a year how "econometric" modeling promises to be the solution, there is little to show for this new approach – at least, we have not seen anything yet. Because of the slow progress in the past and the experience of unfulfilled expectations, we remain skeptical that the emerging modeling approach will offer a significant improvement over previous approaches or that it will be ready with satisfactory results in time for the 2004 budget. Therefore, we request that OMB keep all of us up to date on the progress of the modeling through periodic briefings with our staff so we have an opportunity to ask questions.

Continued use of overly conservative assumptions in the credit reform model for both of these programs and the resulting continuation of downward re-estimates could undermine support for Credit Reform, which we do not want to see happen. The bias in the estimates for these two programs is simply unacceptable. We do not expect perfect subsidy rate estimates year-in and year-out, yet we do expect that over time the re-estimate will be randomly distributed around zero. One year the estimates may be high and the next year they may be low, but over time they should balance out. Unfortunately, that is not true today, and we are not optimistic that change will occur, absent your active intervention, any time soon.

Repeated opportunities to address this problem have not been realized. We believe the problem has dragged on too long. At a minimum, we expect the Administration to submit and support a budget amendment for 2003 for sufficient subsidy appropriations that will make possible \$11 billion of 7(a) loan volume given the too-high subsidy rate OMB is currently using. Alternatively, if you expect that a review of the 2003 submission will reveal mistakes in the subsidy rates that would allow OMB to execute the 2003 budget using rates other than those published in the submission, as has occurred in other years, please submit that review. We would appreciate receiving your response to our letter, including the requests for an amendment and periodic meetings, by June 1, 2002. If legislative changes are necessary, we welcome your suggestions.

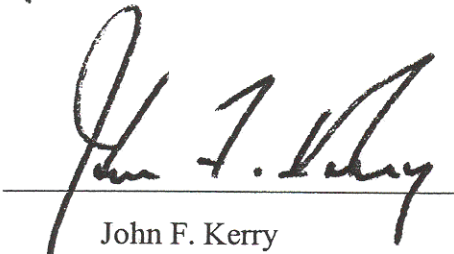
Sincerely,



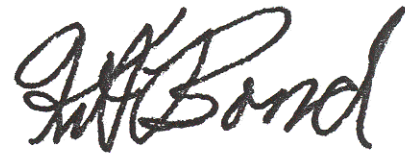
Pete V. Domenici



Kent Conrad



John F. Kerry



Christopher S. Bond