CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas Holtz-Eakin, Director

October 17, 2005

Honorable Judd Gregg
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

As you requested, CBO has reviewed draft legislation for the SBIC Program Restructuring Act of 2005, provided to CBO on July 29, 2005. The draft legislation would modify the Small Business Investment Company (SBIC) program administered by the Small Business Administration (SBA) by creating a new program called the participating debentures program. You requested a cost estimate for the draft legislation, including an analysis of the budgetary treatment of the proposed participating debentures program under the Federal Credit Reform Act of 1990 (FCRA).

CBO expects that the proposed participating debentures program would be considered a credit activity under FCRA. The legislation would direct SBA to assess fees sufficient to fully offset the estimated subsidy cost of the program (as defined in FCRA). CBO estimates that, absent any fees, the new program would have a subsidy cost of between 20 percent and 25 percent on each dollar loaned by SBA. Assuming that the fees are set at the proper level, CBO estimates that the budget would record no net cost to the federal government for this program.

The SBIC Programs

Through two SBIC programs authorized under current law—participating securities and debentures—SBA provides funding to privately owned and operated venture capital firms called small business investment companies (SBICs). SBICs are licensed by SBA and utilize a combination of financing from SBA and the private sector to provide capital to qualified small businesses. Under the participating securities program, SBICs use the funding to make venture capital investments in qualified small businesses and share any profits earned from

those investments with SBA. In general, SBICs use funding from the debentures program to make loans to qualified small businesses.

Prior to 2005, the Administration treated the participating securities program as a credit program under FCRA. Although most government expenditures are recorded on a cash basis, under FCRA, federal costs for direct loans and loan guarantees are recorded on a net-present-value basis. For loans made in any given year, the cost is determined by estimating the net present value of all future expenditures and receipts and recording them in the year the loan is disbursed. Adjustments to this estimate can be made after the year of disbursement as actual information and updated estimates on the performance of the loans become available. Under FCRA, federal agencies administering loan programs have permanent, indefinite authority to record those adjustments—called credit reestimates—on the federal budget.

In March 2005, the Administration informed CBO that it no longer views the SBIC participating securities program as a credit program and that it will record its costs on a cash basis rather than on a net-present-value basis under FCRA. (The Administration has not indicated that it plans any changes in the budgetary treatment of the SBIC debentures program, which is still treated as a credit program.) One of the main features of the participating securities program that merited this revision of budgetary treatment is that under current law, scheduled payments of principal and interest are contingent on profits earned by SBICs. Failure to make scheduled payments does not necessarily result in default.

The SBIC Program Restructuring Act of 2005

The draft legislation would create a new SBIC program, called the participating debentures program, to replace the participating securities program. CBO concludes that the new program should be treated in the budget as a credit program under FCRA. Although the legislative language characterizes it as a guaranteed loan program, we conclude that it would operate as a direct loan program financed by SBA borrowing. CBO estimates that the subsidy rate for the participating debentures program would be between 20 percent and 25 percent prior to accounting for the collection of any fees under the program. The legislation directs that fees be set sufficient to fully offset the estimated subsidy cost of the program.

Participating Debentures. To receive funding from SBA through the participating debentures program, SBICs would issue participating debentures to SBA. Those debentures would represent a pledge of interest payments and a balloon payment of principal at the end of the 10-year maturity. The Secretary of the Treasury would determine the interest rate,

taking into consideration the current market yield on Treasury securities with a comparable period remaining to maturity. (SBA could add an additional charge of up to 1.5 percent per year to help offset the subsidy cost of the program.) SBICs would have a five-year grace period on interest payments, and interest would accrue over that period. On the fifth anniversary of the issuance of a debenture, an SBIC would be required to pay all accrued interest accumulated up to that date. Starting in the sixth year, SBICs would be required to make semiannual interest payments on participating debentures. In contrast to the current participating securities program, failure to make required payments of principal and interest on participating debentures would be considered a default on the loan.

The participating debentures program also would contain a profit component similar to that of the participating securities program. However, before an SBIC would be able to make profit distributions, it would be required to fully repay all principal and interest due on its participating debentures. SBICs would be required to utilize all gross receipts received after full repayment of the participating debentures to make profit distributions to both SBA and private investors. Requirements for profit-sharing with SBA would cease on the maturity date of the original participating debenture.

CBO believes that the participating debentures program should be considered a federal credit activity, but we conclude that it would actually be a direct loan program rather than a guaranteed loan program as the legislative language indicates. Under a guaranteed loan program, a private financial institution disburses funds to borrowers in return for pledges of timely payments of required fees, principal, and interest. The government guarantees a portion or all of those payments. Thus, if a borrower defaults, the government is obligated to repay some or all of the remaining payments due to the private lender. Under a direct loan program, a government agency disburses funds directly to borrowers and collects various fees and payments of principal and interest. When a borrower defaults, the agency loses future payments of fees, principal, and interest. Under the proposed program, the government would be making direct loans to SBICs by acquiring participating debentures.

Agency Borrowing. As it does for the current debentures and participating securities programs, SBA would pool participating debentures from multiple SBICs and sell shares of the pools to the public. The legislation specifies that the federal government would guarantee payments equal to those due from SBICs on the pools of participating debentures. However, the right to profit distributions would be retained exclusively by SBA and would not be included in the pools.

CBO concludes that the pooling mechanism would be a form of SBA borrowing from the public rather than a government guarantee of loans from the public to SBICs. Private lenders would not make loans to SBICs. Rather, SBA would lend money to the SBICs and issue

securities backed by the anticipated stream of income from the loans. The government would receive the proceeds from selling those securities. Therefore, it would be a borrower in that arrangement, not just a guarantor.

Under FCRA, there is no particular reason for the SBA to borrow money from the public for a zero-subsidy loan program. Only the estimated subsidy cost of a federal credit activity needs to be appropriated to an agency for that agency to extend credit under a loan program. The actual cash amounts loaned are derived from a financing account funded by the Treasury. By substituting funds borrowed by SBA for funds obtained by the Treasury, the legislation would result in higher borrowing costs, as investors generally perceive such issues to be less liquid than Treasury bonds.

Short-term Financing Under the Participating Debentures Program. Under the proposed legislation, SBA would pool the participating debentures periodically throughout the year and issue securities backed by those debentures. However, SBICs would be able to issue participating debentures at any time throughout the year. Assuming that SBA needs the proceeds from issuing the pooled securities to lend money to the SBICs, during the period of time between when the SBICs issue the participating debentures and when they are pooled, an interim funding provider (IFP) would provide funding to the SBICs. The legislation directs SBA to provide a 100 percent guarantee on the cash transactions between the SBICs and the IFP.

CBO concludes that the IFP would be an agent of SBA rather than a lender, and therefore no separate loan should be recognized in this transaction. According to SBA, the IFP for the current SBIC programs was selected through a competitive bidding process. Because the IFP would be hired by SBA, that IFP would be an agent of SBA rather than a private, independent lender. We expect that would continue to be the case under the proposed program. CBO concludes that the transactions between the IFP and SBICs would not be separate loans or loan guarantees, but the initial phase of direct loans from SBA to the SBICs.

Estimating Profit Distributions. Potential profit distributions to the federal government are a major feature of both the current participating securities program and the proposed participating debentures program. Although the SBIC participating securities program incurred large losses in many years, profit distributions offset a significant portion of the costs of defaulted participating securities. Under the participating debentures program, profit distributions also could offset some of the cost to the government of the direct loan.

Because the cash flows under the participating debentures program would depend on the financial performance of SBICs, profit distributions received by the federal government

would be similar to returns on a federally owned investment portfolio. In estimating such returns for government investments in private securities, CBO's practice is to use a risk-adjusted interest rate. (See *Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities*, CBO, January 2003.)

Under the participating debentures program, SBICs would use any profit first to prepay interest on the participating debentures, then to prepay principal on both participating debentures and private capital, and subsequently, to make profit distributions to SBA and private investors. SBA has generally provided about two-thirds of total financing for SBICs, but, under the proposal, it would be entitled to less than its pro-rata share in the total investment. CBO estimates that, on average, SBA would receive 17 percent of profit distributions before private investors are fully repaid and 33 percent after private investors are fully repaid. For this estimate, CBO used the Treasury interest rate (the standard proxy for the required return on a risk-free investment) to estimate the cash flow to the federal government from profits generated for SBICs by the participating debentures program. After accounting for the risks of such investments as well as the SBICs' borrowing costs and management fees, CBO projects that profits to the government would be negligible for purposes of this credit subsidy calculation.

Cost of participating debentures. Under the bill, SBA would be directed to set various fees so as to reduce the estimated subsidy cost of the participating debentures program to zero (i.e., a subsidy rate of zero percent). CBO estimates that without such fees, the subsidy rate for loans under this program would be between 20 percent and 25 percent. That means, for example, if SBA were to make $1 billion in participating debenture loans, it would need to collect fees with a total net present value of between $200 million and $250 million to fully offset the cost of loans under this program. The estimated subsidy rate results from costs to SBA for net losses of principal and interest due to defaults. The estimate incorporates a 40 percent rate of default and a 35 percent rate of recoveries on those defaults. We based those assumptions on SBA's experience with the participating securities program, which is similar to the new participating debentures program.

I hope this information is helpful to you. The CBO staff contact for this estimate is Melissa Z. Petersen.

Sincerely,

Douglas Holtz-Eakin
Director

cc: Honorable Kent Conrad
Ranking Member

Identical letter sent to the Honorable Olympia J. Snowe.