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Report to Congressional Requesters

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DEPARTMENT OF VETERANS AFFAIRS

Credit Costs and Risks of Proposed VA Small Business Loan Guarantee Program

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Congressional Requesters

This report responds to a mandate in the Veterans Entrepreneurship and Small Business Development Act of 1999 that we analyze the federal costs and risks of a proposed program for the Department of Veterans Affairs (VA) to guarantee small business loans to veterans for the acquisition of fixed assets used in a business. As agreed with your offices, our objectives were to analyze (1) the federal credit costs and risks of the proposed program, (2) the cost impact of alternative borrower requirements in the implementation of the proposed program, and (3) the administrative issues resulting from VA's implementation of the proposed program.

To address the federal credit costs and risks of the proposed program, we reviewed the credit costs, risks, and program features of the Small Business Administration's (SBA) 7(a) and 504 loan guarantee programs to provide financial benchmarks. SBA's 7(a) program is intended to help small business borrowers who cannot otherwise obtain credit under suitable terms and conditions from the private sector to start or expand a business. SBA's 504 program provides long-term, fixed asset financing through certified development companies to new and existing small businesses to contribute toward economic development.

Results in Brief

The federal credit costs and risks of the proposed program could be similar to SBA's 7(a) or 504 loan guarantee programs, depending on which program it most resembled. A proposed VA program designed like SBA's 7(a) program could require a similar federal credit subsidy because fees collected from program participants likely would not cover federal guarantee payments. Based on SBA's most recent estimates, the credit subsidy rates for the 7(a) program for fiscal years 1992 through 1999 have been under 2 percent. Alternatively, if the proposed program were designed like SBA's 504 program, its credit subsidy rate would be harder to predict. SBA's most recent estimates showed the credit subsidy rates were around 4 or 5 percent for fiscal years 1992 through 1996. Fees charged to 504 program participants were increased in 1996, and the program has not required a federal subsidy since 1997. Based on historical patterns of the 504 program, it is uncertain whether a federal subsidy will be required in the future.

Based on historic experience and the design of the program, including the differing fee structures, the subsidy rate for SBA's 7(a) program is generally expected to be higher than for SBA's 504 program. Our analysis of veteran loan performance indicated that credit costs resulting from borrower defaults on loan payments would be about the same for veterans who could participate in the proposed VA program, as compared with borrowers who participate in the benchmark SBA programs. An economic downturn or other events could increase the proposed program's federal credit costs.

Alternative borrower requirements, such as requiring personal equity as a down payment, have the potential to lower credit costs. We were not able to quantify the impacts of alternative borrower requirements on federal credit costs of the proposed program because SBA does not generally maintain these data for the benchmark programs. In any case, more stringent borrower requirements could make the program less attractive to possible program participants.

VA's lack of experience in administering a small business loan guarantee program could create administrative challenges and may lead to higher administrative costs than the benchmark SBA programs. VA officials said that while they have the expertise to adequately evaluate mortgage applications, they do not have the knowledge and human capital resources to adequately evaluate business loan applications. In February 2000, VA, SBA, and the Association of Small Business Development Centers entered into a Memorandum of Understanding to share expertise with the intent to expand small business opportunities for veterans. Veteran service organization officials said that they would like to see SBA place greater emphasis on providing entrepreneurial outreach assistance to veterans than on the implementation of a new business loan guarantee program.

In this report, we have a matter for congressional consideration addressing expertise sharing between VA and SBA as an alternative to a new program in VA at this time. To take advantage of existing resources and administrative infrastructures, it may be more cost effective to use the current expertise of VA and SBA to expand SBA guaranteed business loan opportunities to veterans. SBA and VA provided technical comments, which were incorporated where appropriate. VA agreed with our conclusions.

Background

The federal government provides guarantees on loans as a mechanism to achieve numerous objectives, such as assistance for home ownership and small business opportunities. Federal guaranteed loan programs generally receive a federal credit subsidy, which equals the estimated present value of net costs to guarantee loans made from an appropriation for the specific fiscal year over the time the loans are outstanding. Each fiscal year, federal agencies offering loan guarantee programs are to calculate the subsidy costs of these programs for budget and financial reporting purposes. Federal agencies operating loan guarantee programs are required to submit annual re-estimates of subsidy rates for loans guaranteed in fiscal year 1992 and forward. These re-estimates are to adjust the original subsidy rate estimates based on actual loan performance. These re-estimates thus reflect the amount of credit subsidy required from or returned to the U.S. Treasury.

SBA operates loan guarantee programs that provide financial assistance to small businesses. SBA's 7(a) program is its largest loan guarantee program and primary vehicle for providing borrowers with access to financing for small businesses. The 7(a) program is intended to serve borrowers who could not otherwise obtain credit under suitable terms and conditions from the private sector. In the 7(a) program, SBA guarantees up to 80 percent on loans made by participating private sector lenders. This guarantee provides lenders partial protection against loan losses when payments are not made. SBA's 504 program provides long-term, fixed asset financing through certified development companies. These corporations are sponsored by private-sector organizations or by state or local governments to contribute to local economic development.
A typical 504 loan requires borrowers to provide at least 10 percent of the project's financing, 50 percent financing from a private-sector lender, and the remaining share from the sale of debentures guaranteed by the SBA.

The dollar volume of 7(a) and 504 loans that SBA can guarantee each year is based on congressional appropriations. SBA guaranteed about $9 billion in 7(a) loans annually in fiscal years 1997 through 1999. SBA guaranteed slightly more than $1 billion in 504 loans annually in fiscal years 1997 and 1998. For fiscal year 1999, SBA guaranteed $700 million, as of February 29, 2000.[1] Veterans received about 15 percent of 7(a) loans and about 7 percent of 504 loans, between fiscal years 1992 and 1999. More detailed information on these programs is presented in appendix I.

VA operates an entitlement program that provides single-family, residential mortgage loan guarantees for eligible veterans to purchase, construct, repair, or refinance homes.

[1] We relied on SBA data on loan disbursements, rather than loan approvals. Loan approvals in fiscal year 1999 equaled about $2 billion.

VA provides private-sector mortgage lenders with a partial guarantee on mortgage loans when loans go into foreclosure. In exchange for the guarantee, VA encourages lenders to offer loans to veterans on terms more favorable than conventional financing, such as requiring small or no down payment. In fiscal year 1999, VA provided loan guarantees on 486,000 mortgage loans with a principal balance of $54 billion. The average loan size was about $110,000. VA officials stated that fiscal year 1999 was one of the highest levels of loan guarantee activity in the program's history, as a result of interest rate decreases that led to an increased level of refinancing activity. Because the VA guaranteed mortgage loan program is an entitlement program, Congress provides VA with a supplemental appropriation when the guaranteed amount exceeds the initial appropriation. More detailed information on this program is presented in appendix I.

The initial authority for VA to provide guarantees for small business loans was made shortly after World War II. In 1974, Congress repealed VA's business loan guarantee authority due to the decreased level of participation. In 1981, VA was authorized to provide loan guarantees for small business loans made to Vietnam era or disabled veterans. This loan guarantee authority expired on September 30, 1986. According to VA officials, this small business loan guarantee program was not implemented because Congress did not provide federal appropriations. VA officials stated that annual appropriations were provided to SBA to guarantee loans to veterans because that agency had greater expertise in business loan matters. VA currently refers veterans to SBA for business loan matters.

Scope and Methodology

The Veterans Entrepreneurship and Small Business Development Act of 1999 mandated that we analyze the anticipated federal costs and risks of a proposed fixed-asset small business loan guarantee program for veterans. We were to assume that up to 10 percent of funds appropriated for the VA guaranteed residential mortgage loan program would be made available for a small business loan guarantee program within VA. We treated this amount as an additional cost and risk to the federal government because the funds appropriated for the VA mortgage loan program cannot be reduced to serve other purposes. Therefore, the government may need to provide an appropriation for the proposed program. We also assumed that the proposed program could take on the design of either SBA's 7(a) or 504 loan guarantee programs. By design, we mean that the proposed program could have similar loan products, terms, underwriting standards, and standard operating procedures as the benchmark programs. Similar to the experience of the 7(a) and 504 programs, the credit costs of the proposed program would be affected by changes in economic conditions.

To help us estimate federal credit costs and risks of the proposed program, we analyzed SBA's 7(a) General Business Guarantee and 504 Certified Development Company loan programs to provide financial benchmarks. We interviewed SBA officials and reviewed SBA information on the administration of the benchmark programs, which included data on fees, SBA standard operating procedures, and program loan performance. We analyzed the benchmark programs' costs and other financial data presented in the fiscal years 1999 through 2001 Budget of the United States Government and the corresponding Federal Credit Supplement: Fiscal Year 2001. We referred to the credit subsidy re-estimates contained in the latter document as fiscal year 2001 re-estimates. Our analysis included consideration of possible differences between federal credit costs of the proposed program and the benchmark SBA programs based on different features of the programs and the small business borrowers served.

To analyze how federal credit costs and risks of the proposed program could be affected by alternative borrower requirements, we reviewed SBA's underwriting requirements.[2] We discussed with SBA officials their independent contractor study of 7(a) and 504 loan programs.[3] We also reviewed the loan performance of veterans and all borrowers who obtained SBA 7(a) and 504 loans. We also analyzed loan performance of veterans participating in VA's residential mortgage loan guarantee program and the participants in the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Program. Appendix II contains our analysis of VA and FHA loan performance. We also reviewed reports on the performance of SBA 7(a) loans from Moody's Investor Services and Standard & Poors and discussed 7(a) loan performance with an official from Moody's.

To identify potential administrative issues resulting from implementation of the proposed program by VA, we interviewed VA officials and reviewed VA's information on its guaranteed residential mortgage loan program. We also met with veteran service organization officials from the Disabled American Veterans, Veterans of Foreign Wars, and Vietnam Veterans of America to obtain their perspectives of the proposed program within VA.

We did not report confidential SBA data specific to veterans' loan performance. We relied on SBA data on costs and loan performance as

[2] Underwriting standards are used to determine which loans are made. Underwriting is the process of identifying the potential risks of loss associated with financial activities to determine loan eligibility, interest rate, and other factors.

[3] Walker & Company, Independent Study of 7(a) and 504 Loan Programs for the Eleven Cohort Years Ended September 30, 1996 (June 16, 1997).

reported to us by SBA. SBA loan performance and credit cost information is reviewed as part of the annual financial statement audits. SBA received an unqualified opinion on its fiscal year 1999 financial statements. We also relied on VA data on annual mortgage loan guarantee amounts and loan performance as reported to us by VA.

We conducted our work in Washington, D.C., between September 1999 and May 2000 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Administrator, SBA, and Secretary of VA. SBA's and VA's written comments are discussed near the end of this letter and are reprinted in appendixes III and IV, respectively.

Credit Costs and Risks of Proposed Program Would Depend on Proposed Program's Design

The federal credit costs and risks of the proposed program could be similar to SBA's 7(a) or 504 loan guarantee programs, depending on which program it most resembled.[4] The design of the proposed program will determine the level of federal subsidy, if any, necessary to support the program. The proposed program likely would require a subsidy if designed like the 7(a) program. However, based on historical data, the proposed program with an SBA 504 design may or may not require a credit subsidy. According to our analysis of SBA data, veteran loan performance in the SBA programs was generally similar to the loan performance of the total loan portfolio for each program.

SBA's 7(a) Program Has Required Federal Subsidies

SBA's 7(a) program has required federal subsidies. As shown in table 1, SBA's original subsidy rate estimates for the 7(a) program ranged from about 1 percent to about 5 percent for fiscal years 1992 through 2001. SBA's fiscal year 2001 re-estimates of credit costs showed that the 7(a) program required a federal subsidy of less than 2 percent for fiscal years 1992 through 1999.

[4] The cost to the federal government of extending or guaranteeing credit is called the subsidy cost. This cost is defined as the estimated long-term cost to the government, calculated on a net present value basis. It excludes administrative costs and any incidental effects on government receipts or outlays. For loan guarantees, the subsidy cost is the present value of cash flows from estimated payments by the government (for defaults and delinquencies, interest rate subsidies, and other payments) minus expected payments to the government (for loan origination and other fees, penalties, and other recoveries).

Table 1: SBA 7(a) and 504 Subsidy Rates for Fiscal Year 1992-2001 Loans

	Subsidy rate (percent)[a]			
	7(a)		504	
Fiscal year	Original	Fiscal Year 2001 Re-estimate	Original	Fiscal Year 2001 Re-estimate
1992	4.85	1.81	0.49	4.96
1993	5.21	1.14	0.54	3.59
1994	2.15	0.82	0.51	5.05
1995	2.74	1.76	0.57	4.20
1996	1.06	0.34	0.00	3.59
1997	1.93	0.02	0.00	-2.71
1998	2.14	0.88	0.00	-1.63
1999	1.39	1.03	0.00	-1.12
2000	1.16	N/A	0.00	N/A
2001	1.24	N/A	0.00	N/A

Note: N/A represents no data available.

[a]The subsidy rate is the credit subsidy received by the program expressed as a percent of the total dollars loaned through the program. It is calculated separately for loans made from the appropriations for the specific fiscal year, called the fiscal year loan cohort. The figures shown in the columns labeled "original" are the estimated subsidy rates calculated for budget purposes prior to the fiscal years. A re-estimate of the subsidy rate is made in each subsequent fiscal year that loans from the cohort are outstanding. A negative rate means that funds are returned to the U.S. Treasury.

Source: Federal Credit Supplement to the Fiscal Year 2001 U.S. Budget.

SBA's 504 Program Has Not Required a Federal Subsidy in Recent Years

SBA's 504 program has not required a federal credit subsidy since 1997, but it did require a subsidy for prior fiscal years. As shown in table 1, SBA's original subsidy rate estimates for the 504 program were less than 1 percent for fiscal years 1992 through 1995. SBA's fiscal year 2001 credit subsidy rate re-estimates showed that the program required a federal subsidy around 4 or 5 percent for fiscal years 1992 through 1996. The 504 program experienced higher than expected credit costs for lending activity from appropriations for fiscal years 1992 through 1996.

For fiscal year 1996 and forward, SBA original subsidy rate estimates showed that the 504 loan program would require a zero credit subsidy. The zero subsidy is required by federal statute. As a result of the zero subsidy requirement, SBA increased the fees charged to borrowers and lenders.[5] SBA's fiscal year 2001 re-estimates showed negative subsidy rates for fiscal years 1997 through 1999. For these fiscal years, the 504 program is now estimated to collect more in fees than paid out in default payments.

[5] The Small Business Investment Act of 1958, as amended, requires SBA to charge additional fees to offset the subsidy costs of the 504 program. SBA is to annually charge certified development companies a participation fee and development company fee. These additional fees became effective October 1, 1996.

Subsidy Rate Re-estimates Provide Better Measures of Credit Subsidy Costs Than Initial Subsidy Rate Estimates

For our analysis of federal credit costs and risk, we used credit subsidy re-estimates because they reflect the actual performance of guaranteed loans up to the date of the re-estimates.[6] Federal agencies' credit subsidy re-estimates are generally different from initial estimates. For example, actual defaults can differ from initial expectations due to unanticipated events, such as major changes in economic conditions that can affect business performance and the borrowers' ability to repay loans. Generally, defaults on guaranteed small business loans increase during economic downturns. When defaults are greater than expected, guarantee program payments and federal credit costs are also greater than expected.

Veteran Loan Performance in SBA Loan Programs Has Been Generally Similar to All Participants

Based on our analysis of SBA loan performance data, veteran loan performance was generally similar to the loan performance of the total loan portfolio for each program. Tables 2 and 3 show the percent of 7(a) and 504 loans guaranteed in fiscal years 1990 through 1999 that were either current in payment or paid in full, as of February 29, 2000. We calculated that an average of 87 percent of all 7(a) loans and an average of 96 percent of all 504 loans were either current or paid in full. Veteran loan performance was generally consistent with these averages for both benchmark programs.[7]

Table 2: Percent of 7(a) Loans Current or Paid in Full for Fiscal Year 1990-1999 Loans

Fiscal year	Total number of 7(a) loans guaranteed	Percent of 7(a) loans current or paid in full
1990	15,832	81.3%
1991	16,511	85.0
1992	21,357	87.9
1993	23,553	88.3
1994	32,270	86.1
1995	48,673	83.3
1996	39,577	83.9
1997	38,301	86.9
1998	34,979	90.7
1999	33,267	96.0

Note: Data as of February 29, 2000.

Source: SBA.

[6] SBA officials told us that SBA's methods and data used to construct the initial subsidy rate estimates have improved over time.

[7] To provide further perspective on loan performance of veterans and all borrower participants, we compared the loan performance of veterans participating in VA's residential mortgage loan guarantee program to that of participants in FHA's Mutual Mortgage Insurance Program. The results are consistent with our findings for veteran loan performance in the benchmark SBA programs. Our analysis is presented in appendix II.

Table 3: Percent of 504 Loans Current or Paid in Full for Fiscal Year 1990-1999 Loans

Fiscal year	Total number of 504 loans guaranteed	Percent of 504 loans current or paid in full
1990	1,378	99.2 %
1991	1,346	98.7
1992	1,826	97.0
1993	2,199	97.5
1994	3,321	93.9
1995	3,803	83.9
1996	5,855	96.7
1997	3,413	98.1
1998	3,680	93.8
1999	2,040	96.2

Note: Data as of February 29, 2000.

Source: SBA.

Proposed Program Could Have Credit Costs Similar to the Benchmark SBA Program It Most Resembled

Because veteran loan performance in the benchmark SBA programs has been generally similar to the loan performance of all program participants, the proposed program could have credit costs that are similar to whichever benchmark program it most closely resembled. The design of the proposed program would greatly affect credit costs or the level of federal subsidy needed, if any. If the proposed program were designed like the 7(a) program, it would be more likely to require a federal subsidy. If the proposed program instead were designed like the 504 program, it would be less likely to require a federal subsidy.

The Impact of Alternative Borrower Requirements on Credit Costs Is Unclear

Because SBA statistics were limited, we were not able to quantify the potential impact that alternative borrower requirements, such as requiring personal equity as a source of down payment, could have on the proposed federal credit costs, including program participation and loan performance. Alternative borrower requirements would appear to have the potential to affect credit costs by affecting loan performance and program participation by affecting the attractiveness of the program. Veteran participation in SBA's 504 program has been less than veteran participation in SBA's 7(a) program. Veteran participation in SBA's 504 program brings into question whether the proposed program with a 504-type design would result in lower veteran participation than needed to utilize the $3 to $5 billion annually.[8] VA could provide inducements to

[8] The Veterans Entrepreneurship and Small Business Development Act of 1999 specifies that the proposed program would allow an amount equal to up to 10 percent of the annual appropriation for the guarantees provided by VA for residential mortgage loans. For fiscal years 1994 through 1999, VA-guaranteed mortgage loans have ranged from $25 billion to $55 billion annually.

attract greater veteran participation, but such actions likely would generate additional federal credit costs.

Relevant Statistics Are Not Readily Available to Evaluate the Impact on Credit Costs

SBA does not generally maintain readily available data that could be used to determine if down payments (i.e., equity contribution) affect loan performance or program participation. Instead, SBA officials said that they analyze business loan performance by concentrating on cash flows and information on the borrower and the business. An official from Moody's that we interviewed, who analyzes SBA 7(a) loan performance, emphasized the difficulty associated with measuring such variables as the loan-to-value ratio on business loans consistently across loan pools. He stated that lenders do not have consistent methodologies for constructing loan-to-value ratios. In addition, since the financial and business skills of the small business operator have a major impact on business success and subsequently loan performance, collecting data on the relationship between borrower down payments and loan performance may be of limited use.

Due to the absence of SBA data that could be used to determine if there is a relationship between down payments and SBA loan performance or program participation, we were unable to determine how down payment requirements would affect credit costs of the proposed VA small business loan guarantee program. Although SBA's 504 program requires a down payment of 10 percent, we could not determine whether this down payment requirement affected loan performance due to the absence of data.

More Stringent Borrower Requirements Could Reduce Credit Costs and Program Participation

In addition to increasing down payments, VA could impose other more stringent borrower requirements to reduce federal credit costs of the proposed program. For example, VA could be given the authority to require borrowers to provide fixed-asset business property, such as real estate or personal financial assets, as collateral. In addition, VA could establish standards that limit the number of years the borrower has for repayment of a fixed-asset business loan or implement high program fees paid by borrowers. While these actions might reduce federal credit costs, such actions also likely would reduce program participation, especially if veterans have access to alternative, more attractive sources of small business loans. For example, veterans may choose to participate in either SBA's 7(a) or 504 programs, if the proposed program had more stringent borrower requirements, such as shortened repayment terms. Furthermore, if VA imposed stringent requirements, veteran borrowers may seek unguaranteed, or conventional small business loans from financial institutions.

VA might also reduce federal credit costs by requiring lenders to pay high fees or offering a low loan guarantee percentage. These actions, directed at lenders, also have the potential to reduce program participation. Such actions may lead lenders to limit or eliminate use of the VA program or charge small business borrowers higher interest rates to cover credit risk exposure or any additional lender fees charged by VA.

Veteran Participation in SBA's 7(a) Program Has Been Greater Than Veteran Participation in SBA's 504 Program

Veteran participation has been greater in SBA's 7(a) program than in SBA's 504 program in terms of both dollar volume of loans guaranteed and the percentage of overall participation in both programs. As shown in table 4, during fiscal years 1992 through 1999, veterans received 12 to 16 percent of SBA 7(a) and 5 to 9 percent of SBA 504 loan dollars. Total annual dollar volume for veterans has been below $1.4 billion for SBA 7(a) loans and below $200 million for SBA 504 loans. Officials from veteran service organizations that we interviewed did not specifically endorse either SBA's 7(a) or 504 program as a preferred design for the proposed program. They emphasized that SBA's role in guaranteeing business loans to veterans could be expanded by SBA's increasing entrepreneurial assistance outreach efforts to veterans. This emphasis appears to center on the business opportunities provided by SBA's 7(a) program more so than SBA's 504 program because entrepreneurial assistance can be more valuable for the start-up, less established small businesses that SBA's 7(a) program is intended to serve.

Table 4: SBA 7(a) and 504 Loans to Veterans, Fiscal Years 1992-1999 (Dollars in millions)

	7(a)		504	
Fiscal year	Loans to veterans	Percent of all loans	Loans to veterans	Percent of all loans
1992	$868.9	15	$35.1	5
1993	995.2	15	41.3	5
1994	1,306.1	15	84.9	6
1995	1,294.2	16	94.3	6
1996	1,191.7	15	172.9	7
1997	1,391.0	15	109.9	8
1998	1,226.7	14	144.4	8
1999	1,198.1	12	181.9	9

Note: Dollar amounts and percentages of loans are based on gross amounts of initial loan approvals.

Source: SBA.

The Proposed Program's Federal Credit Costs Could Be Affected by Inducements to Increase Veteran Participation

As shown in table 4, veterans have annually accounted for less than $1.4 billion in 7(a) loans and less than $200 million in 504 loans. The proposed program could provide about $3 to $5 billion annually in guaranteed small business loans. Thus, the proposed program could represent a large expansion in guaranteed small business loans to veterans in relation to veteran participation in SBA's 7(a) program and especially in relation to SBA's 504 program. Therefore, if VA were to implement the proposed program, there could be incentives to establish low program standards to expand guaranteed loans to veterans. For example, VA may relax business plan standards used in the evaluation of the business loan application package. Such actions could increase the credit costs of the proposed program.

Thus, more stringent borrower requirements would appear to have the potential to improve loan performance and lower credit costs; they also could make the program less attractive to participants. Conversely, less stringent borrower requirements could make the program more attractive to participants, but increase credit costs if there were a decline in loan performance.

VA Would Face Administrative Challenges in Implementing the Proposed Business Loan Guarantee Program

VA's lack of experience in administering a small business loan guarantee program likely would create administrative challenges for the agency to implement the proposed program. Further, the demand for a new, small business loan guarantee program within VA, which could be similar to existing SBA programs, is uncertain. VA likely would initially experience higher administrative costs to implement the proposed program, in comparison to the administrative costs associated with the benchmark SBA programs. While VA has administrative infrastructure and human capital resources that specialize in the review of mortgage loan applications, it does not have similar resources that specialize in the review of business loan applications or the servicing of business loans. VA has access to information regarding veterans' business concerns and a network to facilitate outreach to veterans. VA and SBA have an agreement to exchange expertise pertaining to business loan matters for veterans.

Veteran Demand for a Small Business Loan Guarantee Program Within VA Is Uncertain

Based on current dollar volume of SBA loans to veterans in the 7(a) and 504 programs, it is uncertain if veteran participation in the proposed program would be in the $3 billion or greater range. As shown in table 4, veterans have accounted for less than $1.4 billion and less than $200 million annually in SBA's 7(a) and 504 programs, respectively. Veteran service organization officials said veteran participation in the current set of SBA loan programs likely would increase if SBA were to undertake better outreach efforts to ensure that veterans are provided the same assistance and information as other group participants.

SBA’s Office of Veterans Affairs is to provide increased opportunities for veteran-owned small businesses. This goal is to be achieved by expanding small business procurement opportunities and enhancing entrepreneurial development assistance for veterans. For example, SBA has initiated a new veterans business outreach program, which is to provide business training, counseling, technical assistance, and mentoring assistance to service-disabled veteran entrepreneurs. The Office could provide a focal point within SBA for coordinating with VA in outreach efforts and information dissemination to veterans.

Administrative Costs Per Loan Dollar Likely Would Be Higher Initially In Relation to the Benchmark SBA Programs

VA likely would have higher administrative costs per loan dollar to implement the proposed program in relation to the benchmark SBA programs, even if the proposed program’s funding was fully utilized. According to SBA, the cost of making a 7(a) loan is about $1,000. The cost of making a 504 loan is about $2,000. In addition, SBA incurs annual loan servicing costs for the 7(a) and 504 loan programs.[9] VA likely would initially incur higher costs to perform these same functions until it developed the necessary expertise and program infrastructure.[10] For example, SBA has staff and monitoring systems in place to manage a business loan guarantee program.

VA officials said that the agency does not have the human capital resources to adequately evaluate business loan applications and service small business loans. Officials said that VA would need to hire additional staff, seek technical assistance from SBA, and develop an overall infrastructure to perform the functions associated with a business loan guarantee program.

[9] Loan servicing involves tasks performed by lenders while the loan is outstanding. Such tasks generally include, among others, collecting and recording interest and principal payments; readjusting loan terms, if necessary; and taking actions when borrower loan payments are delinquent. According to SBA, loan servicing costs about $125 annually for a 7(a) loan and about $175 annually for a 504 loan.

[10] VA and SBA delegate authority to lenders to approve and service loans. In this case, expertise required to develop and implement requirements for lenders is similar to expertise required to approve and service loans.

VA's Lack of Expertise in Business Loan Matters Could Make It Difficult to Evaluate Small Business Loan Applications

A review of business loan packages would require expertise in evaluating business performance indicators that would reflect a reasonable expectation of future business prosperity. In contrast, federally guaranteed loan programs for single-family, residential mortgage loan applications require review to ensure borrower credit worthiness and that adequate collateral is present to obtain loan guarantee approval. VA officials said that while the agency has expertise to adequately evaluate single-family mortgage loan applications, it does not have the expertise to adequately evaluate business loan application packages. Agency officials said that they would have to seek expertise from SBA to determine the administrative tasks associated with operating a small business loan guarantee program. If VA were to operate the proposed program without sufficient expertise to adequately evaluate business loan performance, the federal government's credit costs and risk exposure likely would increase.

Servicing Small Business Loans Is Different From Servicing Residential Mortgage Loans

SBA also has experience in servicing business loans, including loans with delinquent payments. While the principal balances of SBA guaranteed business loans generally are larger than VA-guaranteed residential mortgage loans, business loans generally offer less marketable forms of collateral than mortgage loans when delinquent loans default. SBA officials said that SBA makes extensive attempts to keep the borrower in business when loan payments are delinquent. For example, SBA may offer interest rate restructuring to allow the borrower to become current in payment or allow loan payment deferments.[11] According to SBA, for fiscal years 1990 through 1999, of the delinquent 7(a) loans that were purchased by SBA from lenders to fulfill SBA's guarantee commitments, about one-third were cured—returned to current payment or placed in deferment status.

Curing delinquent small business loans is more difficult than curing delinquent residential mortgage loans, as evidenced by a higher cure rate for residential mortgage loans. SBA officials said that SBA has the intent to keep the small business borrower in business when loan payments are delinquent. Likewise, VA officials said that VA undertakes supplemental servicing to keep the home borrower in possession of the borrower's home when mortgage loan payments are delinquent. However, the marketable collateral and direct contribution to the borrower's quality of life provided by an owner-occupied home provides incentives for the borrower to bring

[11] Deferment status results when SBA allows the borrower to defer, or delay, loan payments in return for the borrower's agreement to become current on payment obligations at an agreed upon future time.

delinquent payments current and remain in the home.[12] Therefore, cure rates on delinquent VA-guaranteed residential mortgage loans are greater than cure rates on SBA 7(a) loans. Cure rates on delinquent VA-guaranteed residential mortgage loans have averaged over 80 percent.

Managing collateral on defaulted small business loans is also more difficult than on defaulted residential mortgage loans, because owner-occupied housing provides a better form of marketable collateral. Loss severity rates—the percentage of outstanding loan principal that is lost when loans default are higher with business loans. While SBA has not consistently collected data on loss severity rates, a 1997 SBA-contracted study suggested that SBA's loss severity rates for the 7(a) and 504 programs are in the 70 to 100 percent range.[13] [14]

Veteran Service Organizations Seek Greater Assistance From SBA to Help Veterans in Small Business Matters

Veteran service organization officials that we interviewed focused their concerns on SBA's outreach efforts aimed at veterans rather than the creation of a new small business loan guarantee program within VA. Several officials said that they would like to see SBA put greater emphasis on providing entrepreneurial outreach and assistance to veterans. They would like SBA to increase emphasis on providing veterans with entrepreneurial assistance, such as business plan preparation. These officials believe increased outreach efforts would make it easier for veterans to obtain or expand their own businesses. Officials said they believe that veteran participation in SBA's programs likely would increase with expanded outreach efforts.

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[12] VA-guaranteed residential mortgage loan borrowers have other incentives to bring delinquent mortgage loans current. If a VA borrower defaults, the borrower's eligibility for a future VA-guaranteed home mortgage loan can be reduced or eliminated. In our analysis, we assumed that if VA implemented a small business loan guarantee program, a business default would not restrict the veteran's eligibility for a VA-guaranteed home mortgage loan.

[13] Walker & Company, Independent Study of 7(a) and 504 Loan Programs for the Eleven Cohort Years Ended September 30, 1996 (June 16, 1997).

[14] An official at Moody's, who analyzes 7(a) loan performance, said that loss rates on 7(a) loans backed by real estate collateral have lower loss severity rates than 7(a) loans not backed by real estate.

Agreement Provides for SBA and VA to Exchange Expertise on Business Loan Matters for Veterans

In February 2000, VA, SBA, and the Association of Small Business Development Centers (ASBDC) entered into a Memorandum of Understanding (MOU) to provide entrepreneurial assistance and support to veterans through the small business development centers.[15] The purpose of the MOU is for VA and SBA to share collective expertise with the intent to expand small business opportunities for veterans. The MOU recognizes SBA's and VA's specific missions and their developed administrative infrastructures that are needed to provide veterans with business loan opportunities. For example, the MOU requires (1) VA to compile a list of small business concerns owned and controlled by service-disabled veterans that provide products or services that could be procured by the U.S. government, (2) VA to provide facilities for entrepreneurial training, and (3) SBA and ASBDC to provide training and information to veterans on small business concerns. VA and SBA officials said the MOU was needed to avoid duplicating efforts related to offering entrepreneurial assistance to veterans.

Conclusions

The proposed business loan guarantee program within VA could have similar credit costs and risks to SBA's 7(a) or 504 business loan guarantee programs, depending on which program it most resembled. More stringent borrower requirements would appear to have the potential to reduce credit costs; however, with the absence of data, we could not quantify any such effects. Alternatively, less stringent requirements to induce veteran participation in the proposed program, such as relaxing business plan standards used in the loan application process could increase credit costs.

VA would face administrative challenges in implementing the proposed program. The evaluation and servicing of business loans require different skills, knowledge, and information than home mortgage loan servicing. VA lacks the expertise and infrastructure to adequately evaluate and service small business loans. For VA to implement the proposed program, it said it would have to hire additional staff, seek SBA's business loan expertise, and develop an administrative infrastructure for a business loan guarantee program. While VA has the infrastructure to reach veterans, SBA has the expertise and infrastructure for operating business loan guarantee programs. SBA and VA have entered into an MOU to share expertise with the intent to expand small business opportunities for veterans. Coordination between VA and SBA, such as enhanced training for veterans

[15] This MOU was mandated by the Veterans Entrepreneurship and Small Business Development Act of 1999. ASBDC is a partnership program uniting private enterprise, government, higher education and local nonprofit economic development organizations. ASBDC delivers educational and technical assistance to small businesses regarding business management.

as required by the MOU, could further expand SBA's business loan opportunities for veterans.

Matters for Congressional Consideration

This coordination initiative when fully implemented has the potential to achieve many of the objectives of the proposed VA business loan program by expanding veteran participation in SBA guaranteed loan programs. Given the administrative challenges and costs VA would face in establishing a new program and the initiatives currently under way between VA and SBA, it may be prudent to defer consideration of a new VA loan program. In addition, congressional committees with oversight of veterans' affairs and small business matters may want to encourage even greater expertise sharing between VA and SBA that would take further advantage of the small business loan opportunities offered by SBA to provide business training and funding options for veteran-owned small businesses. Furthermore, the committees may want to monitor closely SBA's outreach efforts aimed at veterans.

Agency Comments

We requested comments on a draft of this report from the Honorable Aida Alvarez, Administrator, Small Business Administration and the Honorable Togo D. West, Jr., Secretary, Department of Veterans Affairs.

We received written comments on a draft of this report from SBA that are reprinted in appendix III. SBA also provided technical comments, which we have incorporated where appropriate.

We received written comments on a draft of this report from VA that are reprinted in appendix IV. The letter stated that VA agrees with our conclusions. In addition, VA provided technical comments, which we have incorporated where appropriate.

We are sending copies of this report to the Honorable Aida Alvarez, Administrator, Small Business Administration; the Honorable Togo D. West, Jr., Secretary of Veterans Affairs; and other interested parties. Copies also will be made available to others upon request.

Please contact me or Bill Shear at (202) 512-8678 if you or your staff have any questions. Major contributors to this report are listed in appendix V.

Sincerely yours,

Thomas J. McCool
Director, Financial Institutions
and Markets Issues

List of Requesters

The Honorable Arlen Specter
Chairman
The Honorable John D. Rockefeller IV
Ranking Minority Member
Committee on Veterans' Affairs

The Honorable Christopher Bond
Chairman
The Honorable John F. Kerry
Ranking Minority Member
Committee on Small Business
United States Senate

The Honorable Bob Stump
Chairman
The Honorable Lane Evans
Ranking Minority Member
Committee on Veterans' Affairs

The Honorable James M. Talent
Chairman
The Honorable Nydia M. Velazquez
Ranking Minority Member
Committee on Small Business
House of Representatives

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Abbreviations

ARM	Adjustable Rate Mortgages
ASBDC	Association of Small Business Development Center
CDC	Certified Development Company
FHA	Federal Housing Administration
Ginnie Mae	Government National Mortgage Association
HUD	Department of Housing and Urban Development
MBA	Mortgage Bankers Association
MOU	Memorandum of Understanding
SBA	Small Business Administration
VA	Department of Veterans Affairs

Background Information on SBA and VA Loan Programs and Loan Requirements

This appendix provides background information on Small Business Administration (SBA) 7(a) and 504 business loan guarantee programs and on Department of Veterans Affairs (VA) guaranteed single-family residential mortgage loan program.

General Description of SBA 7(a) Loan Program

The 7(a) loan guarantee program is SBA's primary business loan program. It provides guarantees for loans to small business owners unable to secure financing under reasonable terms and conditions through conventional lending channels. The 7(a) program operates through private-sector lenders that provide loans that are, in turn, guaranteed by SBA. SBA does not provide funds for direct lending or grants.

For most SBA loans, there is no legislated limit to the total amount of the loan that may be requested from the lender. The maximum amount of an SBA guarantee is generally $750,000. Thus, with a lender receiving an SBA guarantee of 75 percent, the total loan amount available under this program generally would be limited to $1 million. The proceeds of 7(a) loans can be used for most business purposes. These may include the purchase of real estate, machinery, inventory, and working capital.

Business and Loan Applicant Eligibility

Most small businesses are eligible for 7(a) loans. The Small Business Act defines an eligible small business as one that is independently owned and operated and not dominant in its field of operation. Financial assistance, through 7(a) loans, is available for businesses that propose to be engaged in business in the United States or its possessions and for those that operate for profit. SBA determines eligibility based on type and size of business, use of loan funds, and special circumstances. The cash flow of the business is a primary consideration in the SBA loan decision process. SBA also considers other factors, such as the loan applicant's character, management capability, collateral, and owners' equity contribution. SBA requires that all loan applicants that have a 20 percent or greater equity share in the business personally guarantee SBA loans.

Prospective borrowers must take several steps to obtain a 7(a) small business loan. For example, in SBA's small business loan prequalification program, prospective borrowers generally work with a technical assistance organization, designated by SBA, to assist in the preparation of business plans and completion of the loan prequalification application. The technical organization reviews the applicant's credit information, performs a loan analysis, and submits the application to SBA. SBA reviews the completed application to determine whether it meets the requirements of a guaranteed loan and makes an approval or denied decision. If the application is approved, SBA is to issue a prequalification letter stating the agency's intent to authorize a guarantee on the loan. Applicants are responsible for securing a lender interested in making the SBA-guaranteed loan. In addition to this program, borrowers can obtain financing from participating lenders—business lenders that have entered into lending agreements with SBA to provide loans in conjunction with SBA guarantees. Certified lenders are heavily involved in the regular SBA guarantee loan processing and meet certain SBA criteria. Preferred lenders have SBA's full delegation of lending authority and can decide unilaterally on SBA participation in eligible business loans.

Fees, Interest Rates, and Loan Maturities

SBA charges lenders a guarantee and a servicing fee for each loan approved to offset the costs of the loan program to the taxpayer. Guarantee fees can be passed on to the borrower after they have been paid by the lender. The percent of the guarantee fee is determined by the amount of the loan guarantee. When the guaranteed portion of the loan is $80,000 or less, the guarantee fee will be 2 percent of the guaranteed portion. Loans more than $80,000 but less than $250,000 are to have a 3 percent guarantee fee charged. For the next $250,000 of the guaranteed portion, a 3.5 percent guarantee fee will be charged. For any loan portion greater than $500,000, a 3.875 percent guarantee fee will be charged. In addition, all loans will be subject to a fifty basis point (0.5 percent) annualized servicing fee, which is applied to the outstanding balance of SBA's guaranteed portion of the loan.

Processing fees, origination fees, application fees, points, brokerage fees, bonus points and other fees that could be charged to applicants are prohibited.

Interest rates, which may be fixed or variable, are negotiated between the borrower and the lender and are subject to SBA maximums. These maximums are determined by the prime rate. Fixed-rate loans must not exceed prime plus 2.25 percent if the maturity is less than 7 years or prime plus 2.75 percent when loans mature in greater than 7 years. For loans of less than $25,000, the maximum interest rate must not exceed prime plus 4.25 percent. For loans between $25,000 and $50,000, the maximum rate is 3.25 percent and 3.75 percent, respectively.

Variable-rate loans may be pegged to the lowest of either the prime rate or SBA's optional peg rate. The optional peg rate is a weighted average of rates the federal government pays for loans with maturities similar to the average SBA loan. The lender and the borrower negotiate the amount of the spread, which can be added to the base rate. An adjustment period is selected, which identifies the frequency at which the interest rate can change. It must be no more often than monthly and must be consistent, such as monthly, quarterly, or semiannually.

General Description of the 504 Loan Program

SBA's 504 Certified Development Company (CDC) program provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. A CDC is a corporation set up to contribute to the economic development of its community or region. CDCs work with SBA and private-sector lenders to provide financing to small businesses. There are about 290 CDCs nationwide.

Loan proceeds must be used for fixed asset projects, such as purchasing land; improving existing buildings, grading, and streets; parking lots and landscaping; construction of new facilities; or modernizing, renovating, or converting existing facilities; or purchasing long-term machinery and equipment.

A 504 project must have a loan secured with a senior lien from a private-sector lender covering up to 50 percent of the projects costs, a loan secured with a junior lien from the CDC covering up to 40 percent of the costs, and a contribution of at least 10 percent equity from the small business being helped. SBA guarantees a debenture to finance the loan secured with a junior lien from the CDC. The maximum SBA debenture generally is $750,000 but can be up to $1 million, in some cases. The SBA 504 program is designed to enable small businesses to create and retain jobs. The CDC portfolio must create or retain one job for every $35,000 provided by SBA.

Business and Loan Eligibility

Businesses eligible for a loan under the 504 program generally must be operated for profit and fall within size standards set by SBA. Under the 504 program, businesses with a tangible net worth of less than $6 million and average net income not in excess of $2 million after taxes for 2 preceding years are eligible to participate in the 504 program. Generally, the project's assets being financed are used as collateral. Business owners must provide personal guarantees.

Fees, Interest Rates, and Terms

Loan fees total approximately 3 percent of the debenture and may be financed with the loan. Interest rates on 504 loans are pegged to an increment above the current market rate for 5-year and 10-year U.S. Treasury issues. Loan maturities of 10 and 20 years are available.

General Description of the Department of Veterans Affairs Guaranteed, Single-Family Mortgage Loan Program

The principal objective of the VA-guaranteed, residential single-family mortgage loan program is to allow eligible veterans—including members of the selected reserves, active-duty service personnel, and spouses, an opportunity to purchase, repair, or refinance homes for their own personal occupancy. The program serves veterans and military personnel who may not have the financial resources to qualify for conventional loans. The program also encourages private lenders to extend favorable credit terms to veterans for purchasing, constructing, or improving homes. The VA loan guarantee program operates by substituting the federal government's guarantee for a down payment that would otherwise be required when a veteran or reservist purchases a home. The VA guarantee helps protect lenders against partial losses when loans default.

The VA guarantee program provides benefits to veterans and military personnel, but it does not provide that a home is free of defects or that the veteran is making a good investment, and it does not provide legal services.

Guarantee Rates

The actual guarantee amount per veteran depends on the loan amount and whether the veteran had previously used the entitlement. VA will guarantee up to 50 percent of the home mortgage loan with a maximum guarantee amount not to exceed $36,000 per veteran or $50,750 for certain loans over $144,000. VA will guarantee 50 percent of mortgage loans up to $45,000; $22,500 for mortgage loans between $45,000 and $56,250; the lesser of $36,000 or 40 percent for loans between $56,250 and $144,000; and the lesser of $50,750 or 25 percent for loans greater than $144,000. VA can make a maximum direct loan of $33,000 to certain severely disabled veterans to acquire specialty adapted housing grants or $80,000 to Native American veterans on trust land. Lenders will generally limit VA-guaranteed mortgage loans to $203,000 due to secondary market requirements. VA lenders generally issue mortgage-backed securities (MBS) backed by cash flows from VA loans in the secondary mortgage market. The MBS are guaranteed by the Government National Mortgage Association (Ginnie Mae). Ginnie Mae is a government corporation within the Department of Housing and Urban Development (HUD).

Veteran Eligibility Requirements and Lender Responsibilities

Veterans are considered eligible if they have meet certain service requirements since 1940. The maximum entitlement per veteran is $36,000 or up to $50,750 for certain loans over $144,000. Veterans must apply to VA to obtain a certificate of eligibility. This certificate shows the veteran's eligibility to receive the VA housing entitlement and indicates the amount of guarantee that VA can provide. Veterans are responsible for selecting their home and a lender that would honor the certificate of eligibility.

Lenders review the veterans' credit information and request VA to assign a licensed appraiser to determine the reasonable value for the property. Some lenders can generally approve and automatically process veterans' home mortgage applications when income and credit requirements are met. Other lenders must submit the mortgage application to local VA regional offices, which are to notify the lenders of their approval decision.

Fees, Interest Rates, and Terms

The law requires that VA be paid a funding fee for guaranteed loans. The funding fee is paid by all but certain exempt veterans. All funding fees must be paid to VA within 15 days of loan closing. The funding fees for veterans who have not previously obtained a VA-guaranteed loan and whose loan eligibility is not derived from 6 years of service in the Selected Reserve is 2.0 percent of the loan amount for loans with down payments of less than 5 percent. Veterans with at least a 5 percent down payment are to pay a funding fee of 1. 5 percent of the loan amount. Veterans with at least a 10 percent down payment are to pay a funding fee of 1.25 percent of the loan amount.

The funding fee for eligible reservist personnel who have not previously obtain a VA-guaranteed loan is about 0.75 percent higher for each down payment category. Reservists are to pay a funding fee of 2.75 percent of the loan amount for loans with down payments of less than 5 percent. A funding fee of 2.25 percent of the loan amount is charged for loans with at least a 5 percent down payment. A funding fee of 2.0 percent of the loan amount is charged for loans with at least a 10 percent down payment.

The funding fee for subsequent use of the VA-guaranteed mortgage loan program is higher. The fees for subsequent use are 3.0 percent of the loan amount for loans with down payments of less than 5 percent. A fee of 1.5 percent of the loan amount (2.25 percent for reservists) for loans with at least a 5 percent down payment. A fee of 1.25 percent of the loan amount (2.0 percent for reservists) for loans with at least a 10 percent down payment.

The funding fee for interest rate reduction refinancing loans is 0.5 percent. Veterans using partial or restored entitlements for regular refinancing loans will pay a 3 percent fee for subsequent use. Veterans who have not previously obtained a VA loan will pay a 2 percent fee (2.75 percent for reservists) as first time users in conjunction with regular refinancing loans. Also, veterans are charged 1 percent of the loan amount for manufactured homes.

The interest rate of VA loans can be negotiated based on prevailing rates in the mortgage market. The maximum home loan term is 30 years and 32 days. While VA has previously issued guarantees for adjustable-rate mortgages, it currently only offers guarantees on fixed-rate residential mortgage loans.

Loan Performance Is Similar for VA and FHA Fixed-Rate Residential Mortgage Loans

In this report, we compared the loan performance of veterans with all participants in SBA's 7(a) and 504 programs. This appendix provides a related comparison on residential mortgage loan performance. Veterans participating in the VA-guaranteed, single-family mortgage loan program are compared with participants in the Federal Housing Administration's (FHA) single-family mortgage insurance program. Although this comparison may not be directly related to loan performance on federally guaranteed small business loans, we include the comparison to provide further perspective on the issue of veteran loan performance. A detailed discussion of VA-guaranteed, residential single-family mortgage loan program is in appendix I.

General Description of the FHA Mortgage Insurance Program

FHA is a government corporation within HUD. FHA insures mortgages made by qualified lenders to persons to purchase or refinance homes. The FHA mortgage insurance program helps borrowers by lowering some costs associated with obtaining mortgage loans. FHA mortgage insurance protects lenders against the risk of loan default. In the same manner as VA-guaranteed loans, FHA-insured loans generally sell on the secondary mortgage market in the form of MBS guaranteed by Ginnie Mae. FHA loans are protected by FHA's Mutual Mortgage Insurance Fund, which is funded by borrower premiums.

Terms and Conditions of FHA Mortgage Insurance Program

The main advantage of FHA mortgage insurance is that the credit qualifying criteria for borrowers are not as strict as conventional financing. FHA generally allows potential homeowners to finance approximately 97 percent of the value of their home purchase through their mortgage. Thus, borrowers can make a minimum 3 percent of the sales prices as a down payment. In addition, FHA insurance also allows borrowers to finance many closing costs; therefore, loan amounts can exceed 97 percent of home value.

FHA insurance also limits some of the fees lenders may charge borrowers for making the loans. The loan origination fee, charged by the lender for the administrative cost of processing the loan, may not exceed 1 percent of the mortgage amount. FHA sets limits on the dollar value of the mortgage loan. According to HUD, as of January 1, 2000, FHA established mortgage limits ranging from $121,296 to $219,849. Borrowers seeking mortgages that exceed FHA loan limits can increase their down payment or finance under a conventional mortgage. Borrowers pay an up-front insurance premium at the time of purchase, which is generally added to the regular mortgage payment.

While the VA program guarantees fixed-rate residential mortgage loans, up to 30 percent of FHA-insured mortgages annually can be adjustable-rate mortgages (ARM). ARMs insured by FHA have experienced higher loan delinquency and foreclosure rates than FHA-insured, fixed-rate mortgages.

Fees

To cover some of HUD's costs for FHA loans, HUD assesses home buyers fees, such as up-front and annual renewal mortgage insurance fees. The up-front fee for a 30-year loan is 2.25 percent of the loan amount (or 2.0 percent for a 15-year mortgage). This fee is charged to borrowers when they close on the mortgage loan and can be included in the mortgage payment. Borrowers purchasing a condominium are exempt from paying the up-front mortgage insurance premium. Borrowers pay a 0.5 percent annual renewal insurance premium. The mortgage insurance premium collected from the borrower is to help defray costs associated with the program.

Loan Performance on Fixed-Rate Mortgages Is Similar for VA and FHA Borrowers

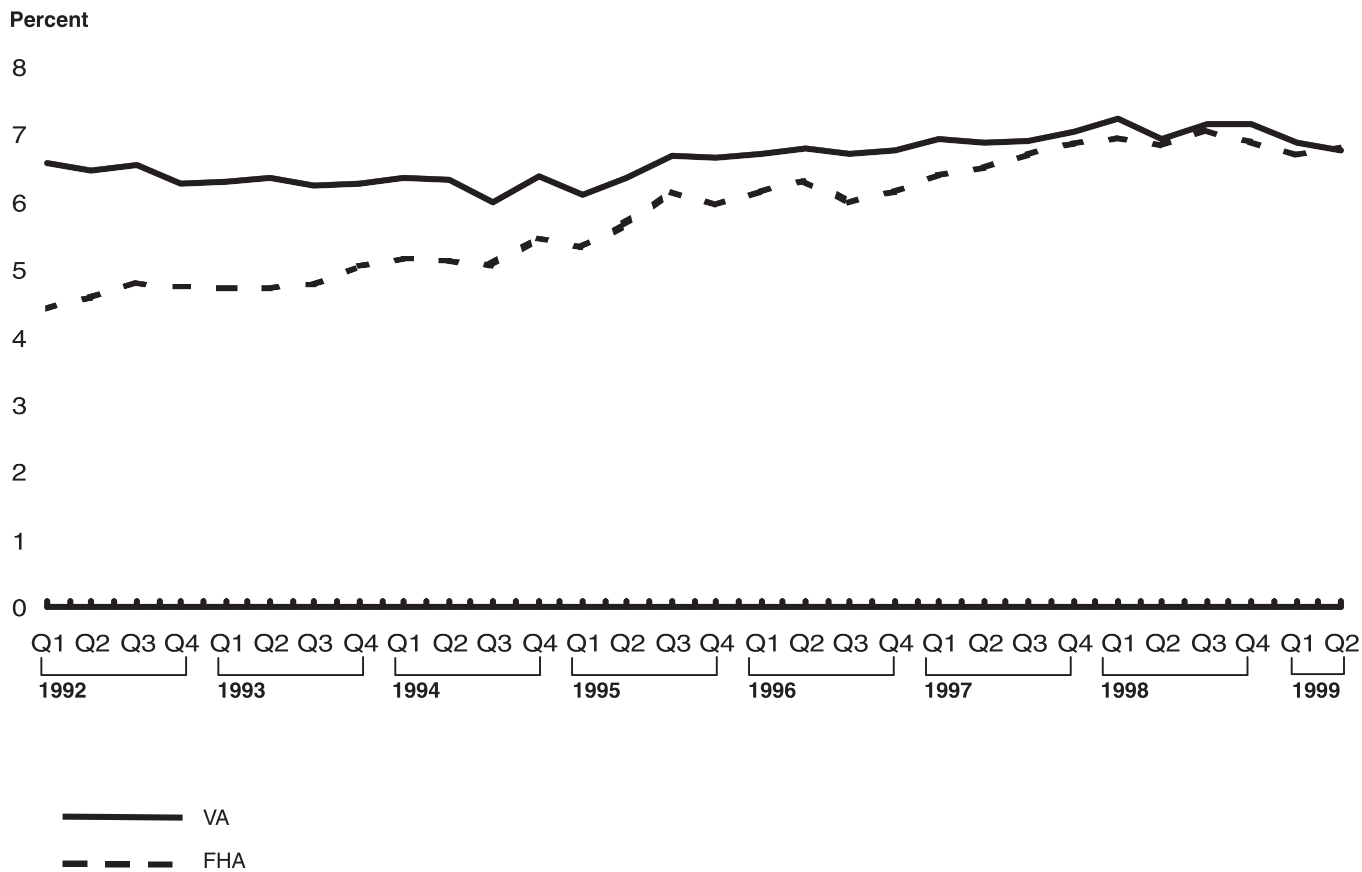
The Mortgage Bankers Association (MBA) conducts the quarterly National Delinquency Survey (the MBA Survey). The MBA Survey collects data from over 180 lenders, including mortgage bankers, commercial banks, savings banks, savings and loan associations, and life insurance companies. The MBA Survey includes about 25 million mortgage loans on single-family residential properties. We used data for fixed-rate VA and FHA residential mortgage loans because VA guarantees fixed-rate mortgages. We collected data on loans with borrower payments that were 30 days or more delinquent and loans where foreclosure had been initiated. The MBA Survey reports these measures as a percentage of loans outstanding during each calendar year quarter.

VA and FHA loan delinquency rates and loan foreclosure rates are presented in figures II.1 and II.2, respectively. Veteran performance in the VA residential loan program appears to be fairly similar to loan performance for borrowers in the FHA residential loan program. This finding is consistent with veterans' loan performance in SBA's guaranteed small business loan programs.

We also obtained loan performance data on VA-guaranteed and FHA-insured, fixed-rate residential mortgage loans included in Ginnie Mae guaranteed MBS. These data indicated similar veteran loan performance in the VA residential loan program and FHA fixed-rate mortgages.

In addition, we obtained loan performance data from VA that distinguished between active duty borrowers and other veteran borrowers in the VA-guarantee program. Active duty borrowers had slightly higher foreclosure rates than other veteran borrowers. However, based on our analysis, we have concluded that excluding active duty borrowers would not affect our findings based on comparing VA borrowers participating in VA's guarantee program and FHA borrowers participating in FHA's insurance program.

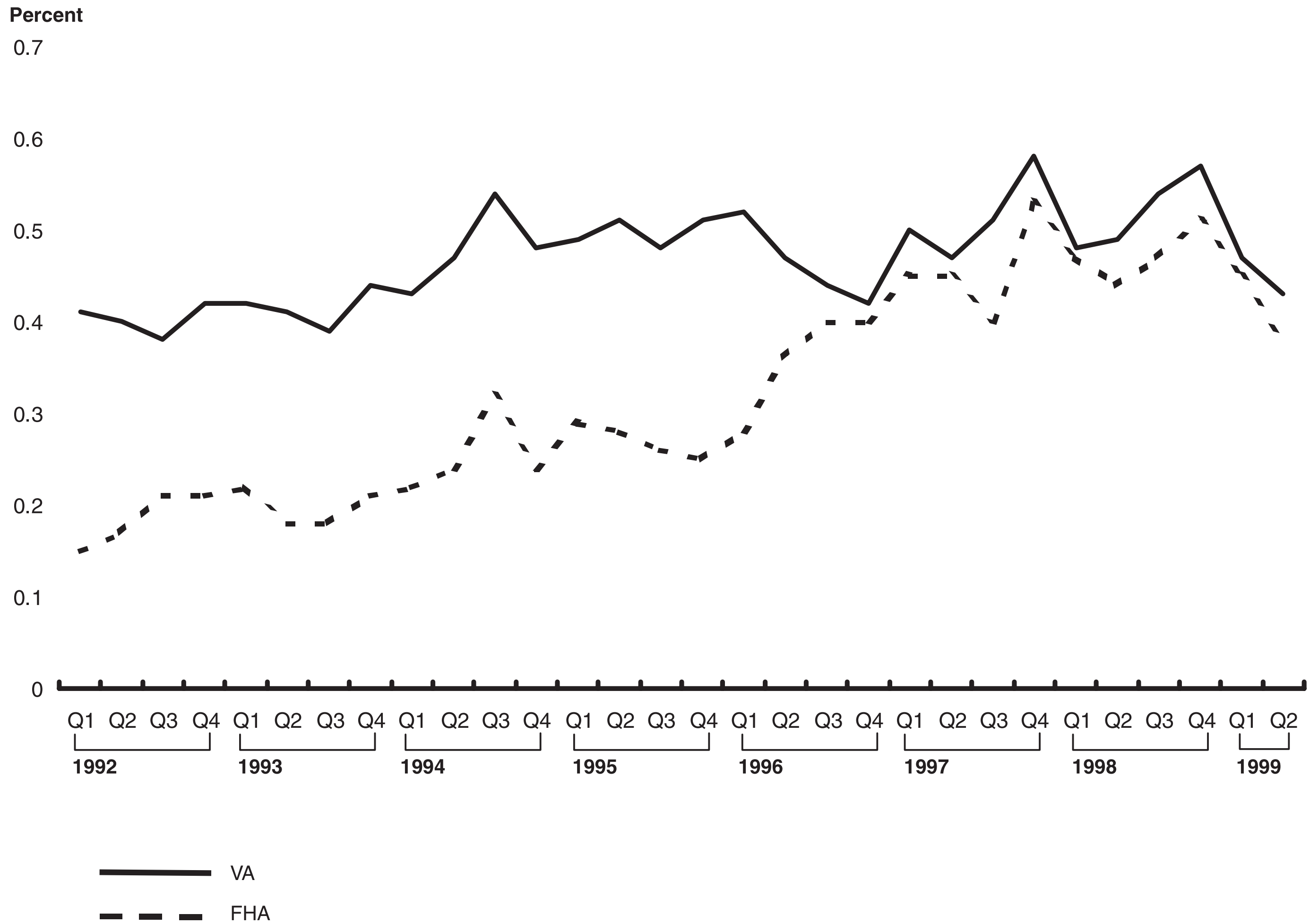
Figure II.1: Percentage of Outstanding VA and FHA Loans Delinquent 30 Days or More



Note: VA mortgage loans outstanding were predominately fixed-interest rate loans. (VA no longer guarantees variable interest rate loans.) FHA guarantees both fixed and variable interest rate loans. This graph shows all VA loans and only fixed-interest rate FHA loans.

Source: MBA.

Figure II.2: Percentage of Outstanding VA and FHA Loans for Which Foreclosure Was Started During the Quarter



Note: VA mortgage loans outstanding were predominately fixed-interest rate loans. (VA no longer guarantees variable interest rate loans.) FHA guarantees both fixed and variable interest rate loans. This graph shows all VA loans and only fixed-interest rate FHA loans.

Source: MBA.

Comments From the Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

June 13, 2000

Mr. Thomas J. McCool
Director
Financial Institutions and Market Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

Thank you for providing your proposed report entitled Department of Veterans Affairs: Credit Costs and Risks of Proposed VA Small Business Loan Guarantee Program for review by the U.S. Small Business Administration (SBA) prior to its release.

SBA has reviewed the draft report. We are very pleased by the strengths of our loan programs which have been described by the General Accounting Office. We are prepared to provide the Department of Veterans Affairs with any advice and technical assistance they might require to implement a new veterans' loan program referenced in PL 106-50.

If SBA were asked to add a new veterans loan program to our current programs, we would have a number of requirements to prepare our operations for more capacity, as well as obtain additional subsidy funding based on the final design of the program. If the final design of the program changes our current underwriting standards, it could affect our existing program subsidies. Most important, the SBA's resources already are stretched thin without the addition of a new loan program. We are proud of the growth of our programs during the past decades but we have had to do so with a 24 percent reduction in staff. For example:

- During the first 4 decades of SBA's life, from 1953 to 1993, our loan portfolio grew to $25 billion. In the last 5 years, from 1993 until today, it doubled to nearly $50 billion.
- Each year we make between 45,000 and 50,000 loans, three times the number made in 1990. Yet, the cost to the taxpayer has been reduced by 80 percent – from more than $5 to $1.16 for every $100 guaranteed under our 7(a) general business loan program.
- Through its Small Business Investment Companies, SBA now provides about half of the venture capital financing made each year to small businesses, thereby helping to develop the market for this type of capital for small business financing.

Mr. Thomas J. McCool Page 2

- During the past decade, Congress has authorized dozens of new programs. In the 106th Congress, about 10 percent of all new laws create or expand SBA programs that we have implemented successfully such as the Office of the Ombudsman, Women's Business Center Program, Veteran's Program, HUBZones, and the Y2K Action Loan program. Despite the additional responsibilities, SBA's funding has remained virtually level and only two small programs have been eliminated.

With the growth in our programs, and the reduction in our personnel, we are very reluctant to consider any additional programs without a corollary discussion of additional resources. It is for this reason that we want to urge caution in proposing the addition of programs to SBA.

We would like to further note that Public Law 106-50, the Veterans Entrepreneurship and Small Business Development Act of 1999, enhanced SBA's interagency cooperation with the Department of Veterans Affairs by improving and increasing financial outreach efforts to present and potential veteran entrepreneurs. These efforts will improve veterans' access to SBA's financial and technical assistance programs. Further, by providing specific language regarding financial assistance to veteran-owned businesses, the law facilitates the purposes of both SBA's microloan and 504 programs. In addition, the law also provides financial assistance for military reservists called to active duty and to small businesses which employ reservists in key positions.

Please see the suggested revisions enclosed in the draft report.

If you need additional information or have any questions regarding our comments, please feel free to contact Gregory Diercks, SBA Assistant Administrator for Financial Programs Operations, at 205-7538.

Sincerely,

Kristine M. Marcy
Chief Operating Officer

Enclosure

Comments From the Department of Veterans Affairs

DEPARTMENT OF VETERANS AFFAIRS
WASHINGTON DC 20420

JUN 9 2000

Mr. Thomas J. McCool
Director, Financial Institutions and Market Issues
General Government Division
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. McCool:

We have reviewed your draft report, ***DEPARTMENT OF VETERANS AFFAIRS: Credit Costs and Risks of Proposed VA Small Business Loan Guarantee Program*** (GAO/GGD-00-XX). We agree with your statement on page 5 that "it may be more cost effective to use the current expertise of VA and SBA to expand SBA guaranteed business loan opportunities to veterans" rather than to establish a new business loan program within VA.

We have informally provided your audit team with several minor corrections and comments, which we understand have been incorporated. Thank you for the opportunity to comment on your draft report.

Sincerely,

Dennis Duffy
Assistant Secretary for
Planning and Analysis

GAO Contacts and Staff Acknowledgments

GAO Contacts

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William B. Shear, (202) 512-4325

Acknowledgments

In addition to those named above, Joan M. Conway, Christine J. Kuduk, and Sindy Udell made key contributions to this report.

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