THE PRESIDENT'S PROPOSED BUDGET FOR THE SMALL BUSINESS ADMINISTRATION FISCAL YEAR 2003

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, DC

FEBRUARY 13, 2002

Serial No. 107–43

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

78–450 WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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SMALL BUSINESS ADMINISTRATION FISCAL YEAR 2003 BUDGET REQUEST

WEDNESDAY, FEBRUARY 13, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 2:00 p.m., in Room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo (chair of the Committee) presiding.

Chairman MANZULLO. The Small Business Committee will come to order. We have two panels today. The first panel is Administrator Barreto. He is going to testify. Members will be able to ask questions. Then he will be excused. The reason you are all seated together is that I wanted to move this because we are in the middle of campaign finance reform votes, and we may be interrupted at least once and probably twice.

I am going to defer to Ms. Velázquez for an opening statement and then I may give one later on. Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman, and welcome all of you, and Administrator Barreto, thank you for being here.

We are here today to review the administration's priorities for this Nation's most vital economic enjoin: small business. I need not remind anyone that small business is big business in America, accounting for almost half our GDP, half our jobs, and 75 percent of all new jobs created. In a faltering economy, small businesses are especially important to communities struggling with low growth and high unemployment. They held us out of recession a decade ago and into the strongest peacetime economy on record. They did it before, and they can do it again with a little help on our part.

I would like to welcome Administrator Barreto here today, and I personally commend you for outstanding leadership in your first year on the job under the most trying circumstances. Speaking for my constituents in New York, I want to thank you for your commitment to the recovery of our city. Today we see the difference your leadership has made. I am pleased that you have prevailed on the White House to offer a more realistic budget request for the Small Business Administration this year.

Last year the Bush administration sent us a Draconian proposal that cut SBA spending in half. That slash-and-burn method of accounting threatened many programs vital to supporting our Nation's entrepreneurs. I remain concerned that while this current budget has some positive components, it still shortchanges the fastest growing sector of American enterprise: minorities, women and low-income entrepreneurs. This budget forfeits our commitment to those businesses.

The administration and OMB have proposed to zero out a number of programs dedicated to creating business opportunities and jobs where our recent prosperity has not reached. The cuts will eliminate the new markets program, PRIME, BusinessLINC and the one-stop capital shops. These initiatives are dedicated to focusing financial resources on small businesses in low-income communities.

The President says he wants to create new jobs. He should support the programs doing just that in neighborhoods that need jobs the most. But the most glaring ongoing problem facing us is the treatment to the 7(a) program. Last year the administration tried to kill this program outright by imposing new costs. This year they are trying a new tact by cutting the program in half. Either way, old or new tricks, the outcome is the same. Small business' access to capital is blocked.

Last year we worked in a bipartisan fashion to make the 7(a) program more affordable for both the lender and the borrower by reducing the cost of the program, which I might add even the CBO said continues to overcharge lenders and borrowers by $1 billion. This overcharging is the result of a miscalculated subsidy rate. Instead of providing an accurate subsidy rate, this administration instead chooses to play Russian roulette with the 7(a) program, and I believe we need to be clear about just exactly what it is—it is tax, yes, it is a tax—and what it will do to small businesses. This tax results in $5 billion less in available capital for those businesses. That money could be pumped into the economy through small companies to create jobs. Instead, the ongoing miscalculation means that the field of dreams will go fallow, as $5 billion do nothing but sit in a ledger somewhere.

I want to be clear. While the Bush administration may have inherited this problem, it is clearly your problem alone now, and there is only one solution: Fix the subsidy rate. Members of this Committee will tolerate nothing less. It is time that we stop using small businesses to subsidize the United States Treasury.

Mr. Chairman, this budget request comes at a critical juncture. While the country tries to recover from the recession, we should be looking for every tool available to shore up the foundation of our economy and prosperity, American small businesses and entrepreneurs.

I think this budget request goes far to recover from last year's damage, but much more can be done. I would like once again to reiterate my appreciation for the administrator's hard work and leadership during a very difficult time, and look forward to cooperating with both Administrator Barreto and you, Mr. Chairman, to solve the problems that face us. Thank you.

[Ms. Velázquez's statement may be found in appendix.]

Chairman MANZULLO. Thank you very much. I went over the budget, and everything looks good, and my only comment is that there is a problem with the subsidy rate. But for the first time in 8 years there is a continued and earnest dialogue going with OMB, the SBA, and our office, with a trustworthy promise that the subsidy rate is going to be not only seriously addressed but is going to be fixed. I look forward to your testimony.

Administrator, if the bell goes off, we will just play it by ear. Thank you.

[Mr. Manzullo's statement may be found in appendix.]

STATEMENT OF HECTOR BARRETO, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. BARRETO. Thank you very much, Mr. Chairman, Ranking Member Velázquez, and members of the Committee, for inviting me here today to discuss the President's budget request for the SBA for fiscal year 2003. To paraphrase President Bush, there are no Democratic solutions to small business issues, nor are there Republican solutions. There are only solutions. Year after year, the members of your Committee have recognized this and have consistently reached consensus instead of conflict. America's small businesses are better off today as a result of your working together. I know we can continue that tradition.

It is in this spirit that I respectfully ask for your support of the President's budget request of $798 million for the SBA. The President has increased the SBA's budget to provide capital and technical assistance to small businesses and disaster victims so that the SBA may continue making services available to those that need them the most.

This budget reflects the President's commitment to economic security through its support of small businesses and their creation of new jobs. It supports the President's role of government, a role which is not to create wealth, but is instead to create an environment in which entrepreneurs can thrive.

Before we continue our discussion on fiscal year 2003, please permit me to take this opportunity to commend the many Federal disaster relief workers for their role after the attacks of September 11th. In the immediate aftermath of this unprecedented attack on American soil, the SBA mobilized both its disaster and district office employees to open up some 40 temporary disaster assistance offices in New York City and Virginia. Through the dedication of SBA employees, we have delivered to date more than $458 million in disaster loans nationwide; approximately $271 million in disaster loans in New York; and $9.5 million in Virginia and $177 million elsewhere throughout the country.

I am pleased to say that the SBA was on site on September 12th and in many cases canvassed the area, door to door south of Canal Street and beyond, distributing disaster loan applications to small business owners. These dedicated men and women of the SBA worked tirelessly to distribute applications, answer questions, verify damages and process and disburse loans, placing the success of the mission above any personal consideration. The SBA family continues to work long hours, without seeking recognition for their tremendous efforts.

The SBA also rolled out an unprecedented nationwide expansion of the Economic Injury Disaster Loan program to help those small businesses across the country that were adversely affected by the events of September 11th. I am proud to lead an agency that employs such loyal, dedicated, and caring employees. I know you join me in the sentiment and share our commitment to continuing this important work on behalf of impacted small businessmen and women across our country.

Having said that, I now want to address 7(a) funding. In fiscal year 2003 for the first time in many years, the SBA and the Office of Management and Budget worked to make the subsidy rate calculation more accurately reflect changes in the program. In furtherance of that goal, we have contracted with the Office of Federal Housing Enterprise Oversight to create an econometric model to determine the subsidy rate for fiscal year 2004. In the interim, our calculation for fiscal year 2003, which weighs preferred lender loans in proportion to participation in the program, produced a subsidy rate estimate of .88 percent. That is a 20 percent decrease. With the requested appropriation of $85.36 million for fiscal year 2003, this would have resulted in a 9 percent increase in loan volume, producing a record level of loan authority.

However, recently passed legislation subsequently reduced the fees paid by borrowers and lenders for a 2-year period beginning in fiscal year 2003, resulting in a doubled subsidy rate of 1.76 percent and a 7(a) program level of $4.85 billion.

While this statutory change poses a significant challenge to the SBA in satisfying increasing loan demand, we believe that other recent legislation will help us meet this demand. The combined budget authority for the 7(a) program in fiscal year 2002 equals a program level of $13.84 billion. Adding this amount to the fiscal year 2003 program level produces a 2-year program level with an annual average of $9.34 billion. This is consistent with historic levels. While we anticipate a program level of $10.5 billion in fiscal year 2002, we expect a $2 billion in guarantee authority carry over from fiscal year 2002 to support a nearly $7 billion program level in fiscal year 2003.

The current challenge creates an opportunity to examine the 7(a) program to ensure its continued relevance in the current marketplace. One of our concerns is the relationship between the 7(a) program and the 504 Certified Development Company. 7(a) and 504 in some ways compete with each other. The 504 program, formed specifically for job creation, provides financing for real estate and major fixed assets.

We have determined that the 504 program is not reaching its full potential. For example, over 40 percent of the loans provided under 7(a) are large real estate loans, many of which our 504 program could accommodate. Steering those larger real estate loans to 504 will assist our goal of reducing the average 7(a) loan size from roughly $244,000 per loan to a more desirable average of around $175,000. Our aim is to increase the proportion of smaller loans, the type of loans often the most difficult for small businesses to receive.

We are looking at ways to encourage lenders to make smaller loans. Doing so will enable us to better provide loans to small businesses, the businesses that represent 99 percent of all employers and 52 percent of the private work force. An Inc 500 study has shown that a majority of the fastest growing companies started with less than $50,000 in capital. Reducing the average loan size in the 7(a) program will make the SBA an even greater engine in creating jobs and providing for the Nation's economic security. We are confident that our lending partners will work with us to ensure that more businesses which need 7(a) assistance will be able to receive it.

As with 7(a), we have contracted with OFHEO to create an econometric model for the 504 program subsidy rate. We will implement the results in fiscal year 2005, a year later than implementation for the 7(a) subsidy rate, to give us time to evaluate the results of using this model on the 7(a) program before using it on additional programs.

As we attempt to implement these and other reforms to our finance programs, we will work closely with you in Congress to ensure that these programs retain their crucial role in assisting small businesses. In keeping with the President's management goals, we are restructuring the workforce at the SBA. We are investing in the workforce now to produce future savings. This agenda includes increased telecommuting, consolidating servicing centers to reduce overhead and rent, and improving productivity through the use of technology.

Managing for results, working with partners to ensure the effectiveness of programs, is another of the President's management goals, and I have taken steps to deal with the management issues raised by the General Accounting Office and the Inspector General. This budget request includes $1 million for the new Native American Economic Development program, an initiative to establish partnerships with tribes engaged in economic development activity.

The SBA is dedicated to ensuring that all Native Americans who seek to create, develop, and expand small businesses have full access to the necessary business development and expansion tools available through agency programs. This program is a comprehensive initiative designed to meet specific cultural needs and result in small business creation.

The SBA will be looking at doing away with the duplication of programs and making our core programs more effective and efficient.

SBA will celebrate its 50th anniversary in July 2003. In its half-century in existence, the SBA has assisted hundreds of thousands of businesses in their formative stages. Many of those companies have names with which you are all quite familiar; names like Federal Express, Intel, Nike, just to name a few.

We are working hard at the SBA to make sure that the agency retains its leadership position as it looks forward to another half century and will continue to provide crucial assistance to the next Federal Express or the next Intel. As I have taken a close look at our programs and services through my first year as administrator, I have seen what the SBA can do and what the SBA needs to do to keep its programs in tune with the ever-changing economy.

We cannot do this alone. I know that I have spoken with some of you individually, but I want to take this opportunity while we are all here together to enroll you in these efforts. We have an opportunity together to look back at successes, to identify weaknesses where they exist, and to position the SBA whereby it can assist in creating an environment in which entrepreneurship can flourish.

As I mentioned at the beginning of my testimony, the SBA's fiscal year 2003 request is a good one for small businesses and offers a beginning point for us to work in tandem with our partners in Congress to ensure that the SBA remains an effective, relevant agency that provides 21st century service for the small business community's needs. We ask for your support for this budget.

Thank you for the opportunity to appear here today, and I will be happy to answer any of your questions.

[Mr. Barreto's statement may be found in appendix.]

Chairman MANZULLO. Thank you, Administrator. I just have one question. Is it your opinion that based upon moving some loans from 7(a) to the 504, that there are sufficient resources for the demand for loans for the small businesses in America?

Mr. BARRETO. Thank you, Mr. Chairman. As I mentioned before, we usually have a program level somewhere in the vicinity of about $9 billion.

As I mentioned to you, we are looking at a program level this year of about $13.8 billion. We expect a loan volume level this year of $10.5 billion. That is going to give us a carry-over of about $3.3 billion. However, because the subsidy rate will go up in fiscal year 2003, the authority that will roll over from this year to next will be about $2 billion. That is going to get us pretty close to $7 billion in loan volume for fiscal year 2003. We also think that we are going to have excess authority in the 504 program which will get us pretty close to that $9 billion level. If historic performance is a good indicator, we should be pretty close to what we are going to need.

Chairman MANZULLO. Ms. Velázquez, did you want to start now with your questioning or should we go vote and come back?

Ms. VELÁZQUEZ. I guess that we should go vote and come back.

Chairman MANZULLO. Okay.

Ms. VELÁZQUEZ. I have a lot of questions.

Chairman MANZULLO. Okay. We will be right back.

Mr. BARRETO. Thank you very much, Mr. Chairman.

[Recess.]

Chairman MANZULLO. I will call the Committee back to order. And, Ms. Velázquez.

Ms. VELÁZQUEZ. Mr. Barreto, I have a lot of questions on the budget, and I want to really acknowledge the great effort that you put into this budget and the great work that you have done in addressing the 7(a) fees and the work that we did with OMB. But today you are sitting here in the hot seat, and I guess that I have to ask all these questions to you, and I want for you to understand that there are some issues that are very important to this side of the aisle, and so let us go.

Last year you spoke before the lending industry and stated that the subsidy rate will be cut in half. Now we get this budget that proposes to increase the subsidy rate by 70 percent. What happened?

Mr. BARRETO. I do remember speaking at NAGGL in San Francisco, and that was a great opportunity for me to meet with our partners, have an opportunity to meet with the board and really introduce myself to them, and also make a commitment to our partners. We know that we cannot do it alone. We are only as strong as the partnerships that we have, and I think we have had a very good partnership with the banking industry.

In that speech I talked about our commitment to working with OMB on this subsidy rate. It is vital for us that the subsidy rate be reflective of what is actually happening. You know, in my time that I have been here, I am into my sixth month, I think we have made some progress with OMB, but it is a process. It is a process that we are committed to. I said in the speech that we hoped to reduce the subsidy rate up to 50 percent. And that was something for which we were very hopeful. And obviously when OMB is going through their process of developing the subsidy rate, it is a very complicated process. A lot of information goes into it. We were able to get a reduction of 20 percent in that subsidy rate, and all things being equal, we were anticipating a new subsidy rate of .88——

Ms. VELÁZQUEZ. I am talking to you about this budget.

Mr. BARRETO. Yes. I am saying that subsidy rate we had of .88 with the budget that we submitted early on would have accommodated an authority of about $9.7 billion. With the advent of the legislation that passed at the end of the year, that lowered fees to the borrower and the lender, with that new development, OMB raised the subsidy rate to 1.76 percent. That is what is causing our decrease in the total amount of lending authority that we have.

Ms. VELÁZQUEZ. Mr. Barreto, our responsibility here—I am sorry that I have to interrupt you.

Mr. BARRETO. No. Please.

Ms. VELÁZQUEZ. Our job is to pass legislation, and in light of the poor record, we determined that participants were grossly overcharged, and with the passage of S. 1196, there existed a great opportunity to fix the subsidy rate, and you failed to do so. So instead the administration decided to chop the program in half, and then SBA had weeks and weeks to comply with this policy. And rather than fixing the subsidy rate, you chose to cut the program in half.

Mr. BARRETO. We didn't cut the program in half. When we submitted our budget request, it included more money than was approved in the prior year. That level would have accommodated a budget authority for our 7(a) program of $9.7 billion.

Ms. VELÁZQUEZ. Okay. Mr. Barreto, I would like for you to talk to us a little bit about how the subsidy rate is calculated, for the loan programs' default rates drive the subsidy calculation. I would like you to clarify a couple of points for the Committee regarding defaults. It is my understanding, based on the assumption you have provided to the Committee, that the default rate for 7(a) is 12.87. Is that correct?

Mr. BARRETO. Yes, it is. I believe the default rate has actually gone down over time. So 12.87——

Ms. VELÁZQUEZ. So for fiscal year 2000, I want to direct you to an internal SBA memo, or document, where the expected default rate is listed at 8.1 percent. Using a default estimate of 8.1 with your 2003 model would in fact reduce the subsidy rate by 150 basis points to between .25 and .3. That is a huge discrepancy, isn't it? That is not—and let me just finish this. Let us not limit it just to the 7(a) program. For the 504 program, you list a default rate of 8.3, but on page 49 of the agency's budget, you state defaults amount to about 60 to $70 million annually. This is in clear contrast to the figures provided by the industry that show a default rate of less than 3 percent.

Mr. BARRETO. Congresswoman Velázquez, first of all, let me say that I have spent a lot of time with our folks talking about the subsidy rate, analyzing it, seeing what we can do better to work with OMB so that we can reduce it. There are a lot of factors——

Ms. VELÁZQUEZ. Mr. Barreto, I am sorry. Would you please answer my question? Can you please reconcile these discrepancies for the Committee, because from where I sit, it looks like the agency is keeping two sets of books. I want to ask you, who has ownership over the subsidy rate, SBA or OMB?

Mr. BARRETO. We work together on that, Congresswoman, and as you very well know, there are lots of factors that go into calculating the subsidy rate. One of them is the default factor. The other ones are the fees that are charged on those loans. All of those things are factored in. And you also realize that we are talking about a lookback period of a number of years, and so all of those things factor into the subsidy rate.

I will confess, I am not an economist, and it is one of the reasons why we felt it was so important for us to outsource the study of our subsidy rate to OFHEO. OFHEO is going to do very sophisticated econometric models that I think will probably enable us for the first time to get some very, very accurate measurements.

With regards to the figures, obviously the SBA does not keep two sets of books. We would be more than happy to provide you a complete clarification on all of the numbers that you asked for. If you would like, I have with me today Dr. Lloyd Blanchard—we are very fortunate to have Dr. Blanchard with us. As you know, Dr. Blanchard worked for the Office of Management and Budget, is a subsidy rate expert, and is now working for us as our Chief Operating Officer. We are very glad to have him on board. Not only is he a very talented manager and executive but somebody that truly understands all of the intricacies on how these subsidy rates are calculated and somebody that I think will be able to help us to make that progress that I know you and I are both committed to.

As I said, this is a process that will continue. This subsidy rate issue, I know, has been something that has troubled this Committee for many, many years.

Ms. VELÁZQUEZ. Let me just share with you that last year at the semiannual meeting of the 7(a) lenders, a former OMB budget examiner of SBA said that OMB first decided upon the 7(a) policy it wants, then can cut the subsidy number to support the policy, and this is why we have progress default numbers going into the subsidy model. So that doesn't look like a partnership to me. They decide, OMB, the policy on 7(a), and then they cut the numbers.

Mr. BARRETO. I can't speak to what has happened with OMB in the past. I can speak to the relationship that we have with OMB now. This administration has been on board for a year, and I will tell you that when I first got on board, our folks weren't talking with OMB on a very consistent basis. That is completely changed. We are working very closely with OMB, and I think that OMB shares our interest to make sure that we have a model that is much more reflective on the actuality of the results.

Ms. VELÁZQUEZ. Well, I guess that—look, I know that you are not going to answer my question. You know, you provided this—these are the numbers provided by your agency. Here you have got 12.7, and on the other one you have 8.1. These are not my numbers. So, Mr. Chairman, I guess that we have here the wrong person. We need to bring OMB, the director of OMB here, and the economic adviser, so that we can get to the bottom of this issue.

Chairman MANZULLO. I agree. I think we have got a spot 2 weeks from now, and let us bring him in. What is the date that—Doug? Two or three weeks from now was—what date is it? March 27th.

Ms. VELÁZQUEZ. We will have the commissioner down here and Mr. Lindsey.

Chairman MANZULLO. Oh, bring them all in. Let us get this thing cleared up once and for all. If someone is cooking the books, they can fry some cake here.

Ms. VELÁZQUEZ. I haven't finished, Mr. Chairman. Okay. Great.

Mr. Barreto, now I want to talk to you about the priority issue you proposed in your proposed regulations that you issued on January 28th that established parity between the 8(a) program and the HUBZone program. You and I had a meeting on this, and I made myself very clear to you, but to be on record, it is my opinion that you are putting something in place that is contrary to the agreement made between the House and the Senate in 1997. I am not working on this issue today. I have been working on this issue since I first came to this Committee, and it was because I raised the issue with Aida Alvarez, the previous administrator. We got into an agreement with the Senate in which it was clear that it was not the intent of Congress to bring parity into this issue and to put the HUBZone program and the 8(a) program on equal footing.

So in fact what you are doing with this regulation by—you are doing something by regulation that Congress wouldn't do in 2000. This proposal was rejected in a bipartisan fashion, and you are also doing something here that the courts wouldn't do, at a time when doors to the 8(a) program decline by half a billion dollars. And I hope that your legal counsel is here. Is he here?

Mr. BARRETO. No, ma'am, he is not here.

Ms. VELÁZQUEZ. Well, he should read the record. From fiscal year 1999 to fiscal year 2000, the numbers of 8(a) have declined by 34 percent over the past 3 years. You really couldn't have picked a worse time to impose something that will further harm the program, probably past the point of repair.

In your testimony, you state that many 8(a) companies are located in areas designated as a HUBZone. Well, the figures I got from SBA tell me that less than 25 percent of 8(a) firms are eligible as HUBZone companies, and only 17 percent of 8(a) firms are certified in the HUBZone program, far from many.

You also state in your testimony that your goal is to treat the 8(a) program and the HUBZone programs equally and not as competitors.

What you have done with your proposed regulations is the exact opposite, creating increased competition. Given this reality, why are you moving forward with this?

Mr. BARRETO. Thank you, Congresswoman Velázquez, and I do appreciate the opportunity that we had to talk about this issue last week. First of all, I want you to know, and I know that you do know this, that I am committed to creating contract and procurement opportunities for small business every possible way that we can. Our intention by coming out with this clarification—and that is the reason that we did it. There was a lot of confusion. Does HUBZone have priority over 8(a)? Does 8(a) have a priority over HUBZone? Which one is the program? And everything that our general counsel has told us in reviewing the regs and the law is that the actual clarity would be to state for the record that neither one of those programs has a priority over each other.

Ms. VELÁZQUEZ. Sir——

Chairman MANZULLO. I am going to have to interrupt at this time. We are going to be met with the tyranny of time, and we have a witness that is here from Oklahoma. We are going to have one more vote, then we are going rapid fire on 20-minute votes in a row, and before we lose all of our time here, I am going to have to reclaim the time.

Ms. VELÁZQUEZ. Mr. Chairman, this is a very important issue——

Chairman MANZULLO. No. I understand it is important, but here is what I am going to do. On February 27th, we are going to have the OMB here and the SBA, whoever is in charge of size standards, whoever you want. You let me know from OMB, and we will have them here to clear this up.

Ms. VELÁZQUEZ. This is an issue——

Mr. WILKINSON. Mr. Chairman, there is a Senate hearing also in the morning. On the morning of the——

Chairman MANZULLO. Well, that is fine. We will do it in the afternoon. We will be here all day. Dr. Gram has said he would come.

Ms. VELÁZQUEZ. Mr. Chairman, I——

Chairman MANZULLO. I have got to be fair to these other witnesses, Ms. Velázquez. I know this is extremely important to you.

Mr. Davis, do you have any questions? We have no questions down here. If you wanted to yield your time to Ms. Velázquez, or whatever you want to do or—wait a second. I am sorry. Mr. Bartlett had one question.

Mr. BARTLETT. Yes. Thank you very much. As you know, we are increasingly losing our noninformation technology base to overseas. This is becoming a national security issue. We cannot be dependent on technologies from overseas to meet our national security interests. Some of these small business contractors—and many of them are small business. Some of these contractors cannot remain in business to make sure that we have an industrial base necessary to meet our national security needs without some help. They need help in terms of grants.

Now, this is a national security issue. How do we get you all working with the Defense Department so that we can keep some of these companies—one, for instance, is a small business that does Milspec aluminum casting, almost unique in this country. A lot of people do aluminum casting. It is not Milspec and it will not meet the requirements of the military. He is going to be out of business unless we can find a grant for him somewhere, and then the military is going to have to go overseas somewhere for Milspec aluminum castings.

We shouldn't have to do this. It is the wrong thing for our country to be increasingly dependent on overseas firms to produce some of these components that we use in our military systems. How can you all work with the Defense Department to identify areas in which you can make monies available in the form of grants rather than contracts?

Mr. BARRETO. Thank you, Mr. Congressman. We are working with the Defense Department, and we are aware of this issue. And I couldn't agree with you more. I think that there is a national security issue with regards to small business being able to compete and have a level playing field.

One of the things we have done is have the Defense Department over to our shop at least two or three times already. We are having ongoing dialogue with them, and we are talking to them about a whole host of issues. Obviously we already are doing some technology grants through our SBIR program, through our STTR program which is very important, but we need to be looking at everything we are doing with regards to contracting.

We have had some good feedback. What we are saying to the Defense Department that small business has to be part of this solution. They are the engine that drives our economy, and they need to be part of this. And they agree.

One of the things that we are planning on doing, coming up later this year, is we are going to have a procurement expo, if you will, an opportunity here in Washington, D.C., which we would love for you to participate in, we invite the whole Committee to participate in, where we bring together buyers from the Defense Department and match them up with small businesses on a whole variety of issues, not just procurement. But we also want to talk about venture capital, access to capital, and technical assistance.

We think those kinds of efforts, bringing people together, facilitating relationships, will create the right kind of synergy so that we can get more results. We are moving in that direction. We are committed to it and any input or ideas that you would like to provide, we would be happy to receive them.

Mr. BARTLETT. If it is okay, I would like to introduce you to this specific individual problem as an example of the kind of problem that we face pretty much across the spectrum, of trying to keep these real specialty small businesses in place so they can meet our national security needs. We will interface with you directly if that is okay.

Mr. BARRETO. Absolutely. I would be happy to receive that, Congressman.

Mr. BARTLETT. Thank you.

Mr. BARRETO. Thank you.

Mr. BARTLETT. I would like to yield the balance of my time to Ms. Velázquez.

Chairman MANZULLO. Ms. Velázquez, about 3 minutes.

Ms. VELÁZQUEZ. Thank you, sir. Well, I want to state for the record that this is a very important issue for our members, and I would like to request to hold a hearing on the HUBZone and 8(a) programs.

Chairman MANZULLO. We will take a look at that. I can't promise it. I just gave a hearing on February 27th at which OMB will have a witness. That is pretty good.

Ms. VELÁZQUEZ. Well, you didn't give it to me, sir. You are giving it to small businesses who are paying, who have been overcharged, not to me. What we need to do——

Chairman MANZULLO. Ms. Velázquez, it is at your request.

Ms. VELÁZQUEZ. Okay. Mr. Barreto, let us talk about the 8(a) program again and the HUBZone programs. You just stated that there was some confusion in terms of clarity in the language. So, you know, I am not a lawyer, but when it comes to legal opinions in this town particularly, we could make a joke about how many and different opinions there are. So bring to me and clarify for this Committee, how did you arrive at the conclusion that it was the intent of the United States Congress to bring parity for the 8(a) and the HUBZone programs?

Mr. BARRETO. Our general counsel provided a chronology of all of the legislation, when it was enacted, and what the spirit of the legislation was attempting to do. And one of the things that he communicated to us was that we were obligated to provide a clarification on this issue. And, again, I want to state for the record, at no time do we want to undermine the 8(a) program. The 8(a) program is a very important program.

We know that the 8(a) program has been sliding, as you have said, Congresswoman. We are very, very aware and focused on that. We don't think that it has been sliding because of HUBZone. We think that it has been sliding because of government credit card purchases, multiple award contracts, government-wide acquisition contracts, Federal supply schedule contracts, and, you know as well as I do, contract bundling. All of those issues have affected the 8(a) program.

We are tackling that issue on two fronts. First we are looking at what we can do on each one of those so that we can stop the bleeding, if you will. The second thing that we know that we have to do because the 8(a) program has been a great program——

Ms. VELÁZQUEZ. Sir, but I am asking you, how did you arrive, or your legal counsel, to the conclusion based on this statute? Tell me where in the statute are you obligated to issue regulations that will bring parity to——

Mr. BARRETO. I would be more than happy, Congresswoman, to provide you a copy of that chronology and the legal brief that our general counsel——

Ms. VELÁZQUEZ. No. I can read your legal brief. Tell me in the statute where do we say—where do we say that it calls for this regulation so that we bring parity into this?

Mr. BARRETO. One of the concerns—in this legal opinion that was written, was that there was a possibility that HUBZones could give priority over any other contracting program; i.e., 8(a). And so one of the things the proposed rule does is let us clarify that. You know, HUBZones does not have priority over the 8(a) program. These programs are a parity——

Ms. VELÁZQUEZ. Okay. Let me read for you what it says, what the statute says. It says that notwithstanding if you are going to apply—based upon the fact that paragraph 31(b)(2)(8) states, notwithstanding any provision of law, the contracting officer may—it doesn't say "shall"—may award sole-source contracts to qualified HUBZones. Can you explain that to me?

Mr. BARRETO. No, ma'am. I don't have that in front of me. And, again, when we are interfacing with our Federal procurement representatives, at no time do we say this program should get most of the contracts. In fact, oftentimes what will happen is that the contracting officer will make a determination based on what goals are not being met inside of the agency. We at no time want to undermine the 8(a) program or give any signal that 8(a) contractors need not apply——

Ms. VELÁZQUEZ. Mr. Barreto——

Chairman MANZULLO. I am going to give a signal here. We have to conclude this hearing within 40 minutes.

Ms. VELÁZQUEZ. I am going to ask for a——

Chairman MANZULLO. No. I understand that, but I am going to have to deny it at this point. I have been very generous on time.

Ms. VELÁZQUEZ. I am going to ask for an extension on the comment period from 30 days to 90.

Chairman MANZULLO. Oh.

Mr. BARRETO. Ms. Velázquez, I will be glad to work with you. I will go back to our legal counsel and see where we are in this whole process, and whatever we can do to help you—you know, I understand the position that we took. We will be more than glad to do that.

Chairman MANZULLO. Thank you.

Ms. VELÁZQUEZ. It is your decision, Mr. Chairman.

Chairman MANZULLO. No. I am the Chairman. He is the administrator.

Ms. VELÁZQUEZ. No. Mr. Administrator.

Chairman MANZULLO. He might as well be the Chairman. He has got the power here.

Mr. Davis, do you have a couple of questions?

Mr. DAVIS. Yes, I do. Thank you very much, Mr. Chairman, and——

Chairman MANZULLO. Can you push the mike closer to you?

Mr. DAVIS. Well, I will tell you, it generally works anywhere I put it.

Notwithstanding your intent, all of the analysts that I have spoken with, all of the experts, all of the business groups, have pretty much concluded that the reg that you are proposing will in fact undermine or do damage to the 8(a) program. That is their conclusion. I mean, for the last several days that is all that I have been hearing. I mean, that is what the telephone calls that I have been getting have been suggesting. And I know that you have indicated to the Ranking Member that you are willing to work with that and to look at it and try and see whether or not it can be rethought, and I appreciate that.

Then I will go on to my next question. In all of the years that I have been working with small businesses, especially those in low-income and distressed communities, one of the biggest problems that are always raised is the issue of access to capital. I am saying people are wringing their hands, weeping and wailing, moaning and groaning, gnashing of the teeth, access to capital, I mean, that—and yet I am having difficulty understanding how we could propose not to fund the venture capital new markets proposals and programs that some of us have been working on now for the last several years and felt so good when finally on the last day of the session, the last session of Congress, they were passed, and we were all gleeful and thought that something had been accomplished. What is the difference now as opposed to then?

Mr. BARRETO. Thank you, Congressman, for the question. I couldn't agree with you more. I think venture capital is very, very important. Everything that we know about venture capital shows that when a company receives it, their chance for success over the future multiplies exponentially. In period of 3 years, they have 100 employees and they are well on their way.

The problem and I think that you are alluding to this—is that venture capital hasn't gotten to every community. I am originally from California, and California had the benefit of receiving a lot of venture capital, especially in Silicon Valley and other places in California, but not every community got it. I think it is important that we are looking at our programs, especially as it relates to venture capital.

New Markets Venture Capital was a pilot program that we implemented. We are reviewing that program right now. We are making sure that it works and that it does everything that it is supposed to do to get venture capital into those communities—not only because it is the right thing to do, I think it is the right thing to do—but because it is the smart thing to do.

We are also working with our general venture capital community. I saw Lee Mercer a little while ago. I had an opportunity to address his members at their national convention, and I talked about this issue.

Mr. DAVIS. I can agree with that, but how do you reclaim much of distressed America if there is no special focus put on those areas and those communities which have problems that are unique based upon all of the things that have been happening?

For example, in my congressional district, we have lost over 120,000 manufacturing jobs in the last 30 years. One hundred and twenty thousand. Something has to help stimulate activity in an area like that, and so I have real difficulty.

And I will just end up with a program that doesn't cost anything hardly, something like BusinessLINC. I mean, you can take a little bit of money—we have got a big announcement coming up this month where RR Donnelly & Sons, one of the biggest corporations around, has linked up with a small printing company, minority company, and as a result they are going to be able to expand their operation threefold. And so Donnelly is feeling real good about this, but they did it on their own. I am saying they did it without any assistance from SBA. Think of what could happen if there was some assistance, just to link these kind of opportunities together. It would cost minimum money, practically nothing.

Chairman MANZULLO. We are at the end of your time there. Did you want to respond to that?

Mr. BARRETO. I would be happy to.

Chairman MANZULLO. Do it very shortly.

Mr. BARRETO. We still have $29 million in appropriations for fiscal year 2001 for the new markets. Obviously we will work very closely with our new markets department to make sure that we are doing everything that we can to make that program successful.

With regards to BusinessLINC, I agree with you. These kinds of mentoring opportunities are invaluable, and we are committed to that. We have a lot of programs in place that provide mentoring type of opportunities. The SCORE program is a great example of that, 12,000 SCORE representatives mentor small businesses every single day, and we will continue focusing on those kinds of opportunities. I thank you for the question, Congressman.

Chairman MANZULLO. All right. If you could go ahead, and we have got to move very quickly. The second panel. Otherwise we won't be able to take their testimony.

Mr. CHABOT. I know you are trying to move this along, so I will be very brief and just ask one question for the administrator. Mr. Barreto, in the status report on selected programs in the budget, the assessment for performance of small business development centers, the SBDCs, is, quote, unknown. Could you elaborate on how the performance of an SBDC is evaluated and determined?

Mr. BARRETO. Thank you very much, Congressman, and I will try to make this brief. We have a great partnership with SBDCs. There are over 1,000 in the country, and last year we served about 660,000 small businesses. It is the place that we touch the most small businesses. We have a great relationship with SBDC, with Don Wilson and his team, and we are going to continue working with them. We ask for information on a periodic basis. At the same time, we understand that we need to be very careful on how we ask the information so it doesn't violate anybody's privacy rights.

It is our attempt to make sure that we are getting the necessary intel, if you will, so that we can continue making the program better and serve even more small businesses, make sure that communities all across the country and every community are receiving these very valuable services. I would be glad to provide you with a list of all the information that we request and the reports that we generate based on that information.

[The information may be found in appendix.]

Mr. CHABOT. I would appreciate that. Thank you. And I will yield back the balance of my time, Mr. Chairman.

Chairman MANZULLO. Mrs. Tubbs Jones. I would like to move to the next testimony here.

Mrs. JONES. I only have one question.

Chairman MANZULLO. That is fine, if you could make it quickly.

Mrs. JONES. I absolutely will, Mr. Chairman. And today seems to be the day for Subcommittee hearings on budgets, and unfortunately, that is what happens.

Good afternoon, Mr. Secretary. How are you? My area of focus is specifically on a request that I made to you previously, Mr. Secretary, with regard to credit unions having the ability to administer the 7(a) loan program. And the reason I proposed that is because in many communities across this country, there are no banking institutions who are willing to administer such small loans. I made an inquiry at the last hearing we had. I sent a written letter asking you to do it administratively, and I haven't heard back from you. Can you tell me why?

Mr. BARRETO. Yes. It is great to see you again, Congresswoman, and thank you very much for the question. And I know that this is a very important issue, something that is very near and dear.

We had a great meeting with the Federal credit unions about a month ago, and we will provide you with a status of that meeting. We had a very productive dialogue. I thought it was a very important conversation.

We have received requests from other credit union organizations as well, and we are in the process of setting up those meetings. One of the things that we are in this process of doing is a due diligence, making sure that we understand all the issues and what ability do we have to change our processes, our regulations.

The last thing I want to say on that, Congresswoman, is that we finally have our Associate Deputy Administrator on board. He is here today. Ron. And Ron now is taking——

Mrs. JONES. Raise your hand, Ron, so we know what you look like.

Mr. BARRETO. Ron is somebody that we are very happy to have, a banker's banker, if you will, somebody with a long history in the financial services market. He is working on this issue now. We will be following up with those meetings with the credit unions and will provide you with a status report in the very near future.

Mrs. JONES. Ron, that lady in the gold suit is my legislative director. I want to have her make an appointment to come see you.

Thank you, Mr. Chairman. That is my only issue.

Chairman MANZULLO. Thank you very much, Mr. Barreto, for your testimony. If you can join us on the 27th.

Mr. BARRETO. I would be happy to.

Chairman MANZULLO. That would be fine, but I won't have you join us on March 6th.

Mr. BARRETO. Thank you very much.

Chairman MANZULLO. Mr. Barreto and his wife are expecting their third child on the 6th.

Mr. BARRETO. Thank you, Mr. Chairman. I appreciate it.

Chairman MANZULLO. Appreciate your testimony.

Mr. BARRETO. Thank you, Congresswoman Velázquez.

Chairman MANZULLO. And you are excused. Thanks again.

I am going to go first with Mr. Wilkinson. I am going to limit the testimony to 4 minutes. When you see the red light I am going to gavel it and I am going to insist on it. You are going to stop right in the middle of a sentence.

Chairman MANZULLO. You are up, Mr. Wilkinson.

STATEMENT OF ANTHONY R. WILKINSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Mr. Chairman, Ms. Velázquez, and the other members of the Committee, thank you for inviting me here today on the fiscal year 2003 budget request. I testified before this Committee in May 1997 and reported that the Office of Management and Budget was not calculating a fair, reasonable subsidy rate.

Since then, NAGGL has testified every single year that OMB continues to calculate a subsidy rate far in excess of the government's cost to the program, and OMB has done it again in this year's budget.

In our written testimony for today, the chart on page 1 shows that the Office of Management and Budget has been calculating a subsidy rate that has led to all appropriation dollars provided since 1995, plus another $253 million, being returned to the Treasury, and we believe that the amount that they recognize as a reestimate is a low number and really should be higher. We anticipate that number to grow somewhere between $1.8 billion and $2 billion.

Mr. Chairman, this is simply not fair. It is not reasonable. It is a tax on small business and the lenders who provide 7(a) loans.

Mr. Chairman, we want to thank you for your efforts last year to get report language in the fiscal year 2002 Treasury, Postal appropriation bill. We have appreciated the Senate requesting a GAO review of the subsidy calculation last year and for holding a roundtable hearing last September. We appreciate the tough comments from both sides of the aisle directing OMB to get their act together and calculate a fair and reasonable subsidy rate. But, Mr. Chairman, they have ignored it all. Not only are users of the 7(a) program being taxed, OMB has now ignored the wishes and directives of Congress. It is simply time for a solution.

We must find a way to make the Office of Management and Budget accountable for the decisions that they make. Maybe we accomplish this in the fiscal year 2003 Treasury, Postal appropriation bill. Perhaps it is the hearing we have coming up on the 27th. Perhaps it is a review of the Federal Credit Reform Act, because in our opinion OMB has made a mockery of that act. So maybe it is time for a change in the Federal Credit Reform Act. But clearly something must be done to hold OMB's feet to the fire, make them accountable for the decisions they are making, and quit taxing users of the 7(a) program. NAGGL stands ready to work with you, your staff, and all the members of the Committee to come up with a solution.

Regarding the particulars of the fiscal 2003 budget request, there is really nothing in it for the 7(a) program even worthy of a comment. The budget is an attempt to focus the discussion away from the subsidy rate calculation. It blames Congress for the low 2003 budget levels. It tries to pit one SBA program against another, and lastly it does not address the long-term credit needs of small businesses.

For fiscal year 2003, NAGGL requests congressional support for a $12 billion 7(a) program. SBA anticipates enough carry-over from this year to fund about $2 billion worth of that demand next year. So we need to come up with sufficient appropriations to fund an additional $10 billion in lending for fiscal 2003 at a reported subsidy rate of 1.76 percent. That means we need to come up with $176 million in appropriations, not the $85 million listed in their budget request.

Now, we know that the subsidy rate is once again overestimated because of the high default estimate in the model and that a lot of these appropriation dollars will ultimately be returned to the Treasury. But the SBA through its loan programs is the largest single provider of long-term credit for small businesses in this country. The SBA loan programs are needed by small business and deserve the support of Congress and the administration.

Mr. Chairman, we need your help and the help of all the members of this Committee in getting a fair and reasonable subsidy rate calculation, and we need your help in getting sufficient upfront appropriations to meet the credit needs of small business next year. We stand ready to work with the Committee to achieve these goals. Thank you for having me here today, and I will be happy to answer any question.

Chairman MANZULLO. Thank you.

[Mr. Wilkinson's statement may be found in appendix.]

Chairman MANZULLO. Mr. Black.

STATEMENT OF PHIL BLACK, DIRECTOR OF COMMUNITY ECONOMIC DEVELOPMENT PEOPLE INCORPORATED OF SOUTHWEST

Mr. BLACK. Thank you, Mr. Chair and Congresswoman Velázquez. I appreciate the opportunity to present to you guys today.

I want to talk about programs that are focused on what I would describe as our pre-rich entrepreneurs, or Low Income Individuals program that has benefited those that have entrepreneurial spark, that need access to capital, but in fact they are taken for granted in our mainstream marketplace.

I want to talk about the SBA Microloan program. I want to talk about the PRIME program, and I want to talk about the CDFI program, as well as the program for Women's Business Centers.

There is a concern—and around you have written testimony that details this. We have taken cuts in 2002 in all of these programs, and there is some concern that there is some duplication in funding some of these programs. And I thought I would use my few minutes that I have to try to dispel some of those myths.

The CDFI program is really designed to help build institutional capacity in many of our intermediaries, and it is not necessarily duplicating the work of, say, our PRIME program. Our PRIME program—well, let me talk about—I do have some success stories in here, and I know I don't have any time to talk about those in detail. But the SBA Microloan program, we are an intermediary, and what that means is that we borrow the money from the U.S. Small Business Administration. We pass along no risk to the Small Business Administration. We take care of the risk on a local level, and we take care of any losses. So the government hasn't lost any money. We receive a technical assistance grant with that program to provide vital technical assistance after we make a loan to that individual who does not have a choice to go to a bank in the mainstream marketplace, and then we hold their hand. We provide business technical assistance to them after the loan is made to mitigate the risk of default on the loan, but more importantly to make sure that entrepreneur is successful.

Secondly, we are a PRIME beneficiary this year, the first year of the program. We understand the program has been cut for next year, and what that means under the regulations of the SBA is that if a customer who has that entrepreneurial spark but may have some other barriers, who wants to make a go of having a small business for themselves, who may be a low-income individual and may not have a pristine credit record, is that we won't have any funding to provide technical assistance to help them overcome the barriers, and most likely they will not receive a loan, so they will be out of the mainstream marketplace without PRIME.

So there is a misunderstanding about PRIME being duplicative with the Microloan program, and I would like to see if we could get the facts correct today.

And the CDFI doesn't provide any money for—it focuses on institutional capacity building, not on working with our pre-rich individuals and families that are looking to have their own small business. So, please, I want to emphasize if you will take a look at this. Help us restore funding so we can work with this marketplace that without SBA support, without the support from this Committee, will in fact not receive assistance. Thank you very much.

Chairman MANZULLO. Thank you very much.

[Mr. Black's statement may be found in appendix.]

Chairman MANZULLO. Mr. Mercer.

STATEMENT OF LEE W. MERCER, PRESIDENT, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. MERCER. Thank you, Mr. Chairman, and Ms. Velázquez and members of the Committee. I am pleased to be here on behalf of the SBIC industry, 434 firms managing 20 billion in venture capital assets. And we are pleased to be able to say we support the administration's budget which will provide $4 billion in new participating security leverage and $3 billion in new debenture leverage at no appropriations cost to the government and at no increase in fees to SBICs. So all in all, we believe the budget is a good one.

At a time when the economy needs all the new venture capital it can get, the budget will be welcome by small businesses. All venture capital investments fell by 63 percent in 2001, from 199.6 billion to 36.6 billion. SBIC investments in contrast fell only by 3 percent. So the program is proving to be the most stable platform in the venture capital area, and truly showing its counter cyclical nature.

That role is particularly important for younger companies seeking capital in the 250,000 to $5 million range, a range that statistics show is not met by non-SBIC venture capital firms. A full 58 percent of all fiscal year 2001 SBIC investments were in companies less than 3 years old. The average investment was 1 million, and the median investment sizes were much less.

Of particular interest is the fact that a full 22 percent of the dollars invested, almost $1 billion, was invested in small businesses located in low- and moderate-income areas as defined by the government. It shows that good businesses do exist in these areas and that the SBICs are more than willing to support them when they are brought to their attention.

The administration's budget will continue the growth of the SBIC program during a difficult economic cycle. Fifty-one funds were licensed in fiscal year 2001, bringing with them a new $1.1 billion in private capital. We hope to see a similar number of funds licensed this year with a similar amount of new private capital.

Regarding fund-raising, as we did last year, we asked you to help us change the Internal Revenue Code so that we could eliminate debenture indebtedness from the class of indebtedness characterized as acquisition indebtedness, which creates unrelated business taxable income for tax exempt investors such as pension funds, university endowments, and charitable organizations.

These tax exempt investors provide the majority of capital that goes into venture capital funds, and if we can eliminate that barrier for debenture funds, we believe that we can have that program grow at a rate similar to that of the participating security program.

Finally, we applaud the administration for applying more personnel to the investment division. I testified last year that I thought this was a very important area. And the administration has responded. And we also hopefully look forward to a new head of the investment division. And I spoke with Administrator Barreto today, and he said they are proceeding as fast as they can. Thank you very much.

Chairman MANZULLO. Thank you very much.

[Mr. Mercer's statement may be found in appendix.]

Chairman MANZULLO. Mr. Crawford.

STATEMENT OF CHRISTOPHER L. CRAWFORD, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF DEVELOPMENT COMPANIES

Mr. CRAWFORD. Thank you, Mr. Chairman. I would like to thank you, Chairman Manzullo and Ranking Member Velázquez, as well as the Committee for the support of the 504 program. With your help, the CDC loan program has gone to over $5 billion in 504 loans annually, of which 2.5 billion this year will be guaranteed by the SBA. The remainder will be funded through private first mortgages. SBA has proposed an authorization of $4.5 billion for us this year, and we support that level. However, the annual fee charged each small business increases from 0.410% to 0.425%. Mr. Chairman, I am absolutely dumbfounded by this proposal to get even more cash out of our borrowers.

The program is supposed to pay for itself through fees. It does that and far more. Since we went to zero subsidy in 1997, we have paid the Treasury $400 million in excess fees and interest. SBA forecasts that we will pay almost $90 million in 2003. Even paying fees over and above inflated cost estimates, the administration demands still more from small businesses by increasing fees. This is truly an unwarranted tax.

These problems come from two sources. First, the estimate of loan defaults is 8.3 percent. Attached to my statement is a chart that shows the loan defaults for the last 12 years are nowhere near 8 percent. Amazingly, as Congresswoman Velázquez pointed out, the President's own budget supports our estimates, not the SBA's forecast. Page 49 of the Budget Request and Performance Plan admits that the true defaults for 504 are $60 to $70 million annually. This is a very accurate statement and is supported by the Bank of New York, our trustee. On an annual volume of about $2 billion, the real defaults are averaging 4.5 percent or even less.

Second, we see problems with their guesstimates of loan recoveries. They forecast collection of 58 cents of every dollar on defaulted loans. However, they will spend 38 cents to make that recovery, leaving a net recovery of only 20 cents on every dollar.

Our CDC liquidation program, which is a pilot authorized by this Committee, averaged about 55 percent recovery. At the same time, SBA indicates that their own recoveries through the asset sales are at least 50 percent. Where did the money go? It didn't go into recovery expenses. CDCs are shouldering their own costs for the pilot. It shouldn't have gone into the asset sales. The whole purpose of going to the asset sales is to eliminate both servicing and recovery expenses for the agency, as many of you will recall.

Our subsidy problems have led to inflated fees and have certainly made 504 what I would characterize as nothing less than a Treasury cash cow. Borrowers are paying hundreds of millions of dollars in excess fees and are now told they are going to pay even more. We strongly object to this fee, and we need your help.

I ask this Committee to get to the bottom of the administration's questionable assumptions. Without your intervention, I fear that we will continue to pay these excessive fees, thank you for allowing me to make these comments.

Chairman MANZULLO. Thank you.

[Mr. Crawford's statement may be found in appendix.]

Chairman MANZULLO. Mr. Wilson.

STATEMENT OF MR. WILSON, PRESIDENT & CEO, ASSOCIATION OF SMALL BUSINESS DEVELOPMENT CENTERS

Mr. WILSON. Thank you, Mr. Chairman, Ranking Member Velázquez, and members of the Committee. We are appreciative of the opportunity to come here today and comment——

Chairman MANZULLO. Could you move the mike to you, Mr. Wilson? Thank you.

Mr. WILSON [continuing]. To you on the SBA budget. I am pleased to report to the Committee that the state of the SBDC program is relatively strong. In 2001 we saw about a 4.6 percent increase in the number of clients that we serviced, and we are up to 610,000 clients who are receiving an hour of counseling or 2 hours of training. That does not count probably another 700,000 who are receiving incidental help of less than an hour. Of those clients, 43 percent are women, 24 percent are minorities, 7 percent are self-declared as veterans.

These are 2001 numbers, Mr. Chairman. The concerning thing is that as the economy contracted, beginning this year, the start of this fiscal year, 24 States received severe reductions in funding, and the ability to supply services to a small business community that is in greater need than ever before.

The U.S. Conference of Mayors released a survey within the last 10 days indicating that 76 percent of small businesses do not anticipate hiring new employees this year. If those numbers are anywhere near accurate, we are not going to see the recovery that some people are hoping for. Now, if that recovery doesn't come and if revenues continue to fall off the table, all of the programs that this government wants to fund are not going to have the resources.

And we are pleased to see a 4 percent increase in the SBA program. And in relation to what the administration recommended for the SBDC program last year, the $88 million is welcome. But let me make it perfectly clear: $88 million is a phrase that is used as level funding. The 24 States, your State, Mr. Chairman, your State, Ms. Velázquez, that received hundreds of thousands in cuts, they don't view that $88 million as level funding.

Now, for 2003, if we are going to get this economy growing again, it is not going to be big business who is going to lead this. Kaiser went bankrupt. Kmart went bankrupt. The large firms, Fortune 500 firms in the last decade had a net decline in jobs. It is small business who will lead us into a recovery. It will be small business who will produce the revenues this government desperately needs. And yet if you look at the SBA 4 percent increase, I have had several of my friends in the small business trade association community point out that salaries and expenses at SBA received a 20 percent increase. So overall, the program growth must be down. The overall growth is 4 percent and salaries and expenses is up 20%, then program growth has to be less than even.

One of the things that I have heard today, I have heard the administrator say that the agency and OMB aren't talking. I hear Ms. Velázquez and others say that OMB are producing bogus numbers. Look in the budget. Look at the statement that is made about the SBDC program. They indicate that they do not know whether or not this program is effective. If they have such serious doubts, why did they propose a $12 million increase from what they proposed last year. And why do they say we refuse to give data?

OMB has never asked this program for any data, and I am unaware of any data that SBA has ever asked for that we do not give them. As the program managers of this program, we give SBA more data, more complete data, more detailed data, more economic impact data, than any other program. The reason why OMB has its nose out of joint, and perhaps the middle managers at SBA also, is because we have resisted giving them the names, addresses, and phone numbers of our clients. And this Committee seems to agree with us.

[Mr. Wilson's statement may be found in appendix.]

Chairman MANZULLO. Okay. Your time has expired. It is obvious that on February 27th, it is OMB day, perhaps long overdue. And is anybody here from OMB? They never show. But I am very distressed over the complete lack of cooperation between OMB and Members of Congress. Whoever did this budget never asked Members of Congress about whether or not any of these programs is worthy.

Measuring the performance of these programs has been difficult because many factors beyond SBA assistance affects small business sustainability and growth. Has anybody in this room asked anything about the viability of any SBA program by whoever prepared the budget? The people that prepared the budget, maybe we should have them here also on the 27th, but I am just getting fed up with this disconnect that is going on.

Dr. Blanchard, will you be here on the 27th?

Mr. BLANCHARD. Are you asking me to, sir?

Chairman MANZULLO. Yes, I appreciate it. You were at OMB and you spent a lot of time on this. But February 27th is going to be a day of reckoning. I am tired of fighting with OMB. They are not elected officials. They are accountable to no one. People get all over us because we have to face reelection every 2 years. We ask questions. They don't get answered. I am just tired of waiting on OMB. So they can come here and testify on the 27th.

Any of you groups here that have any questions that you want asked of OMB, get them into our staffs, and we will make sure that we get those questions answered and answered sufficiently, if we have to have a hearing that goes on all day.

Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman, and I would like to address my question to both Mr. Wilkinson and Mr. Crawford. What do you think we should do to fix the subsidy rate?

Mr. WILKINSON. Thank you, Ms. Velázquez. We have spent a lot of time and effort in reviewing the subsidy calculation. Our Association has said on many different occasions that we are not going to get hung up with what model they choose to use, but at the end of the day, the number that they calculated should have been reasonable. The GAO report last year showed 7 or 8 different ways that the subsidy rate could have been calculated.

Ms. VELÁZQUEZ. Six.

Mr. WILKINSON. The one that had the highest subsidy rate was the one that OMB uses. The other ones—in particular the one recommended by SBA has been rejected, so this is clearly an OMB problem. But we are not going to get hung up on one method or another.

I would point you back to the 1998 budget when the administrator came in at that point in time. There was money in the budget for econometric study, where they are playing that stall game again this year. Every testimony since 1997 has said we are going to work on the problem, we are going to work on the problem and it is time to fix it.

We are not opposed to the current model. The model is fine. It is the assumptions that drive the result, or as we believe, the desired result drives the assumptions that have to go into the model so they end up with the number they want. But we are happy to work with any kind of model as long as it is fair and reasonable, come the end of the day.

Ms. VELÁZQUEZ. Thank you, Mr. Wilkinson. Mr. Crawford.

Mr. CRAWFORD. As my written testimony indicates, the model is just a bunch of formulas. To me it is irrelevant, although it scares me to death to think that they are going to go to a econometric model. And now they are going to have 5 more years, as I pointed out in my testimony, to reset the game clock to try to get that model right.

I don't think we have a model issue here, I think we have a data interpretation issue here. All you have to do is look at history. All you have to do is look at the chart that I gave you, and you can see that loan defaults for this program haven't changed an iota in 12 years. We have gone from 300 million in loans to almost 2.5 billion in loans, and defaults haven't gone up. That says to me default rates have gone down. When they first took us off budget in 1997, you will remember they projected our default rate at 19 percent. My response to them was, you are smoking dope. Now it is at 8.3 percent. I think they are still smoking dope. I don't know what to say.

Ms. VELÁZQUEZ. Maybe we could strike that out?

Mr. WILKINSON. It is maddening to look at real data——

Ms. VELÁZQUEZ. Let us put it this way, Mr. Crawford. I guess then maybe what we should say is that the problem is not the model, but the numbers. And if we put garbage in, that is what we are going to get.

Mr. WILKINSON. Yes, ma'am you are right.

Ms. VELÁZQUEZ. We are going to get garbage out. Thank you.

I have another question. The administration's solution this year seems to have more 7(a) loans made through 504 programs. What do you think of that?

Mr. CRAWFORD. I have no clue as to what of the 2 billion they think they are going to move to 504 are actually eligible for 504. To start with, we are an economic development program. We create jobs. It is your mandate that we create jobs. I have no clue as to how many of those projects, that his membership does match that job creation criteria. 7(a) does hundreds of different kinds of loans. They do refinances. We don't do refinances. That is a legislative intent. This program was not set up to refinance real estate. So unless you are prepared to pass a whole bunch of legislation to change 504 into a look-alike 7(a) program, I haven't a clue as to how they are going to move 2 billion bucks in loans to our program.

Ms. VELÁZQUEZ. Maybe we need to bring the legal counsel here, too. I have another——

Chairman MANZULLO. Could I interrupt for just a second? Dr. Blanchard, you hadn't answered that last question about the 504 and the 7(a). If you would feel comfortable in answering that—if not, you don't have to.

Mr. BLANCHARD. I would be happy to answer that, sir.

Chairman MANZULLO. Would this be okay with you, Ms. Velázquez? Nobody else has any questions on the panel, so the rest of the time is yours.

Ms. VELÁZQUEZ. Sure. Yes. Be my guest.

Chairman MANZULLO. Dr. Blanchard, do you want to have a seat up here, sir. If you could spell the last name for the record, please.

Mr. BLANCHARD. Thank you, Mr. Chairman. Blanchard is B–L–A–N–C–H–A–R–D.

Chairman MANZULLO. And you are the COO?

Mr. BLANCHARD. I am the chief operating officer of the SBA.

Chairman MANZULLO. Thank you for your graciousness.

Please, Ms. Velázquez, did you want to ask the question again, or do you have——

Ms. VELÁZQUEZ. I guess he heard the question and he heard the reaction of Mr. Crawford to it.

Mr. BLANCHARD. I think it is a legitimate question and I think Mr. Crawford's answer is a legitimate one, in that he doesn't know the extent to which 7(a) loans that are directed toward real estate would satisfy the job creation criteria. This is precisely one of our concerns with the 7(a) loan program, which is to say some of those loans might be used for purposes for which the program was not designed. We now have an opportunity to examine the 7(a) program in a very detailed fashion to determine the distribution of those loans and where they are going. We have found that a very large proportion of the 7(a) loans go for—they are very large loans, and undoubtedly they go for real estate and equipment. We have also found that about 40,000 loans that are given through the 7(a) program, 3,000 borrowers receive almost 50 percent of the loan volume. That suggests a misdistribution of lending in the 7(a) program.

Notwithstanding the comments of NAGGL, we believe that the CDC program through the 504 can accommodate some loans that are being made through the 7(a) program. The question really only is what are the changes that we need to make at the margin that will afford the CDCs and the—the CDCs that opportunity? We are not trying to pit the Community Development Corporations against the banking partners. All we are trying to do is respond to a shortfall in demand that some legislation passed caused.

Ms. VELÁZQUEZ. Mr. Wilkinson, would you like to respond to that?

Mr. WILKINSON. Yes, ma'am, I would. First of all, the delivery system for the 7(a) and the 504 program are different. We have certified development companies to do the 504 program. We have banks and nonbanks throughout the country delivering the 7(a) program. They are different kinds of products. They have different delivery systems. Both products are good. Both products are needed.

First of all, I would like to dispute Dr. Blanchard's claim that 3,000 borrowers are getting more than 50 percent of the dollars. I have an SBA report that shows 75 percent of the numbers or loans are for $250,000 or less, and that even looking at all of the 500,000-and-over loans in the 7(a) program, they accounted for only 30 percent of the dollars, 32 percent of the dollars. So I don't know where that particular number came from. It is very clear to us that a good chunk of our loans are going in the small loan category as you would like.

And Mr. Chairman if I could, I would like to share an e-mail with the Committee that I got from one of our members. It goes: I realize the need and the desire for smaller loans. As an example, our bank is committed to making smaller loans via our conventional program that uses SBA Express as a fall product. We are reducing our risk to reach a borrower that we cannot help conventionally with the use of the 50 percent guarantee that the express product provides.

We are even developing a term product through SBA Express with a loan credit risk scoring rate to be offered to those applicants in low to moderate areas. But this can only be done because the larger, more profitable SBA loans help subsidize the smaller, riskier loans. Without the larger, more profitable loans in our portfolio, we would have to rethink why we would even want to participate with SBA in its loan programs.

Ms. VELÁZQUEZ. Thank you, Mr. Wilkinson.

Mr. Black, I would like for you to explain what type of training and technical assistance do micro enterprise practitioners provide, and how do they differ what from other SBA programs such as SBDC, SCORE, Women Business Development Center provide?

Mr. BLACK. Thank you. That is a very good question. We think of a Microloan program as combining training and technical assistance and capital, and we think they are inextricably linked. And so under the Microloan program we only have a few dollars or a small percentage of the funding formula can go for training. But after we qualify them for a loan—and these are very small loans and these are very risky loans. The primary emphasis of business technical assistance at that juncture is hand-holding.

One is we are selfish, in that we want our entrepreneur to be able to repay the loan and the loan that we make them and that we have to repay the government. And secondly, more importantly, we want the entrepreneur to be successful in their enterprise. We have partnership agreements with the Small Business Development Center. I come from a Small Business Development Center environment, so I understand the importance of their program. And in many cases we have a partnership agreement with our SCORE chapters if they are available, and they are not available in all of our regions. So we graduate them to the Small Business Development Centers for more sophisticated technical assistance.

But a lot of our technical assistance is very fundamental, very essential, and very important to the success of these small businesses.

Ms. VELÁZQUEZ. Thank you, Mr. Black. Thank you, Mr. Chairman.

Chairman MANZULLO. Dr. Christensen, did you have a question? We have got about a minute left before we have to run to vote.

Mrs. CHRISTENSEN. No, you go ahead. I am just catching up.

Chairman MANZULLO. Okay. We have concluded our hearing. I would like to point to page 352 of the budget of the government dealing with the SBA. And, Dr. Blanchard, we have talked several time in the office, and I have tremendous confidence in you, but I would like you to find out who prepared this chart that appears on page 352. I mean, it lists four programs for the SBA. That is the SBIC, Disaster Loan programs, 7(a), and the Small Business Development Center. And under 7(a) it says, moderately effective explanation, "Declining defaults have improved performance." We are very much interested in knowing where that is going to lead. I know where I want it to lead.

But also where it says Small Business Development Centers, where it says "assessment unknown," that indicates to me a complete breakdown in the communication system of the SBA. They never asked any Members of Congress—I have two in my Congressional District, and I can tell you the tremendous work that they do. They keep more people out of business than they do going into new ventures so people don't lose their homes in some risky effort. I mean, the work they do is—it is absolutely unparalleled.

But I think it is reckless and irresponsible for the SBA to present a budget saying that it wants to increase a program, whose assessment is listed unknown, at a rate of 4½ percent. If they don't like it, they should eliminate it or at least sit down with Members of Congress and the different trade groups to assess it.

I know this doesn't please you because I know the type of person that you are, but if you could look into that. I mean, this has to do with improving the communications among SBA, OMB, and Members of Congress.

Thank you all for testifying. We have to go run and vote, and this meeting is adjourned.

[Whereupon, at 3:50 p.m., the Committee was adjourned.]

February 13, 2002

OPENING STATEMENT

CHAIRMAN DONALD A. MANZULLO
COMMITTEE ON SMALL BUSINESS

U.S. Small Business Administration
FY 2003 Budget Request

Good morning and welcome to this hearing of the Committee on Small Business. A special welcome to those who have come some distance to participate and to attend this hearing.

Let me first applaud those parts of the President's budget that emphasize national defense, homeland security, and economic security. A key part of economic security is creating jobs and revitalizing the economy. Small businesses have always led this nation out of economic downturns and they will do so again. The question becomes what can the federal government do – or, in many cases, should not do – to foster a better economic climate for small business.

Key provisions in the President's budget will help revitalize economy. They include:

- Accelerating the bipartisan tax reductions passed by Congress last year, which helps 85 percent of small businesses that pay taxes on an individual, not corporate basis.
- Making permanent the tax cuts passed by Congress, including the all-important estate tax repeal scheduled to take full effect in 2010.

- Reforming the Alternative Minimum Tax (AMT) on business, which helps the remaining 15 percent of small businesses that pay their taxes on a corporate basis.
- Offering better tax treatment for small businesses that invest in new equipment.

I am also very thankful that the President continues to see a positive role for the Small Business Administration (SBA) in helping to promote the interests of small businesses. Unlike the budget situation that faces many other domestic agencies, the President proposes a modest percent increase in spending on the SBA because he understands the importance of small businesses in leading the way in the economic recovery.

I am also grateful that, unlike last year, there is no proposal that requires Small Business Development Centers to charge fees for one-on-one counseling – a proposal that Congress has never supported. There is also no request to increase interest rates for the Disaster Loan program, which is especially welcome in light of the events of September 11th.

The importance of the Microloan program is finally being recognized and the Administration is putting its support behind this program.

Unfortunately, this budget request has one major pitfall. The subsidy rates for the 7(a) and 504 loan programs still do not reflect the actual performance of these loan portfolios over the past 11 years since enactment of the Credit Reform Act. While the subsidy rate calculation has changed to weigh loans originated by the Preferred Lenders Program (PLP) more heavily than other SBA loans, the subsidy rate still does not take into account the other changes made by Congress in 1995 that made the loans less risky to the taxpayer. Simply put, SBA loans made in 1988 are much different than loans from 1998. Yet, the new subsidy rate calculation essentially treats them the same, with the exception of those originated by PLP lenders. The SBA assumes a default rate of 12.87 percent; yet the actual default rate for the past 11 years has been between 8 and 10 percent.

I look forward to an econometric forecasting model that reflects the true performance of the loan programs. However, relief is needed today for small businesses – not at some future time. That's why Congress passed legislation last year to cut 7(a) loan fees in half starting in October in order to provide relief to small businesses who have overpaid the government $1.3 billion over the last 11 years to pay for the cost of running the 7(a) program.

The Administration's proposal that could possibly cut access by small businesses to the 7(a) loan program, as a response to last year's legislation, is simply not acceptable. A realistic subsidy rate calculation could easily have kept the 7(a) program volume operating at historic levels while providing much needed relief to small business borrowers and lenders.

While I welcome the Administration's creative ideas on how to meet the challenge of keeping the 7(a) program open to small business borrowers throughout the next fiscal year, we would not be in this situation if the subsidy rate were on target. I would have thought that after the bipartisan grilling that OMB received in the Senate Small Business Committee last year would have left a lasting impression and caused prompt action. The time is **<u>NOW</u>** to fix the problem.

Again thank you all for participating in this hearing. And thank you in the audience for attending this hearing. I now yield for an opening statement by my good friend and colleague, the Ranking Member, Ms. Velazquez of New York.

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
107th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-0515

STATEMENT
of the
Honorable Nydia M. Velázquez
Ranking Member, Small Business Committee
Budget Hearing, Small Business Administration
February 13, 2002

We are here today to review the Administration's priorities for this nation's most vital economic engine --- small business. I need not remind anyone that small business is big business in America, accounting for almost half our GDP --- half our jobs --- and 75 percent of all new jobs created.

In a faltering economy, small businesses are especially important to communities struggling with low growth and high unemployment. They hauled us out of recession a decade ago and into the strongest peacetime economy on record. They did it before, and they can do it again, with a little help on our part.

I would like to welcome Administrator Barreto here today, and I personally commend you for outstanding leadership in your first year on the job, under the most trying circumstances. Speaking for my constituents in New York, I want to thank you for your commitment to the recovery of our City.

Today we see the difference your leadership has made. I am pleased that you have prevailed on the White House to offer a more realistic budget request for the Small Business Administration this year.

Last year, the Bush Administration sent us a Draconian proposal that cut SBA's spending in half. That slash-and-burn method of accounting threatened many programs vital to supporting our nation's entrepreneurs.

I remain concerned that while this current budget has some positive components, it still short-changes the fastest-growing sector of American enterprise --- minorities, women, and low-income entrepreneurs.

This budget forfeits our commitment to those businesses. The Administration and OMB have proposed to "zero-out" a number of programs dedicated to creating business opportunities and jobs where our recent prosperity has not reached.

The cuts will eliminate the New Markets programs, PRIME, BusinessLINC, and the One Stop Capital Shops. These initiatives are dedicated to focusing financial resources on small businesses in low-income communities. The President says he wants to create new jobs. He should support the programs doing just that in neighborhoods that need jobs the most.

But the most glaring, ongoing problem facing us is the treatment to the 7(a) Program. Last year, the Administration tried to kill this program outright by imposing new costs. This year they are trying a new tack --- by cutting the program in half.

Either way, old or new tricks, the outcome is the same. Small business access to capital is blocked.

Last year, we worked in a bipartisan fashion to make the 7(a) Program more affordable for both the lender and the borrower by reducing the cost of the program --- which, I might add, even the CBO said continues to over-charge lenders and borrowers by one billion dollars!

This over-charging is the result of a miscalculated subsidy rate. Instead of providing on accurate subsidy rate, this Administration instead chooses to play Russian Roulette with the 7(a) Program. And I believe we need to be clear about just exactly what this tax --- and yes, it is a TAX --- will do to small business.

This tax results in five billion dollars LESS in available capital for those small businesses. That money could be pumped into the economy through small companies to create jobs. Instead, the ongoing miscalculation means that the field of dreams will go fallow as five billion dollars do nothing but sit in a ledger somewhere.

I want to be clear --- while the Bush Administration may have inherited this problem, it is clearly your problem alone now and there is only one solution --- *Fix the subsidy rate!*

Members of this committee will tolerate nothing less. It is time that we stop using small businesses to subsidize the U.S. Treasury!

Mr. Chairman, this budget request comes at a critical juncture. While the country tries to recover from the recession, we should be looking for every tool available to shore up the foundation of our economy and prosperity --- America's small businesses and entrepreneurs. I think this budget request goes far to recover from last year's damage, but much more can be done.

I would like once again to reiterate my appreciation for the Administrator's hard work and leadership during a very difficult time. I look forward to cooperating with both Administrator Barreto and you, Mr. Chairman, to solve the problems that face us.

News from Congresswoman
NYDIA M. VELÁZQUEZ
Representing New York's 12th Congressional District • Brooklyn, Manhattan and Queens
Ranking Democratic Member, House Small Business Committee

For Immediate Release
February 13, 2002

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Velázquez Demands Fixes to SBA Budget

Programs for minorities eliminated, 7(a) subsidy problems continue

WASHINGTON – In a hearing today, Congresswoman Nydia Velázquez (D-NY), Ranking Member of the Committee on Small Business, called on the SBA to fix the 7(a) Program subsidy rate and urged funding of minority and low-income business development programs that saw cuts in the FY 2003 SBA budget.

"Last year, the Bush Administration delivered us a draconian proposal that cut half of the SBA's spending," Velázquez said. "I am pleased to see that the worst of such mindlessness is absent from this year's budget proposal. Still, I remain concerned that while the budget has some positive components, it still shortchanges the fastest-growing and most powerful sector of American enterprise – minorities, women, and low-income entrepreneurs."

Once again, the Administration failed to fund the New Markets Initiative, a venture capital and technical assistance program for businesses in low- and moderate-income areas, PRIME (Program for Investments and Microentrepreneurs) for disadvantaged microentrepreneurs, and BusinessLinc, a mentoring program for small businesses in low-income locations. One Stop Capital Shops (OSCS), which offer free counseling and assistance to local businesses found mainly in low-income empowerment zones, have also been zeroed-out.

But perhaps most importantly, the SBA has failed to adequately fund one of its most popular lending programs – the 7(a), which is responsible for almost 40% of all long-term small business loans. Problems with the subsidy rate caused both lenders and borrowers to be grossly overcharged in the last decade. This was pointed out to the SBA and they committed to fixing the problem. But rather than adjust the subsidy rate, the solution proposed will cut program funding in half.

"Last year we worked in a bipartisan fashion to make the 7(a) Program more affordable for both the lender and borrower by reducing the cost of the program," Velázquez said. "Overcharging occurred because of a miscalculated subsidy rate. But instead of providing an accurate subsidy rate, this Administration instead chooses to play Russian Roulette with the 7(a) Program. And I need to be clear about just exactly what this tax – and yes, it is a tax – on small businesses will mean. This tax will result in $5 billion less in available capital for small companies."

--continued--

The 7(a) Program subsidy rate problem, coupled with the funding cuts to minority and low-income business development programs, together cause the FY 2003 SBA budget to fall short for America's small business owners.

"I am pleased this budget proposal reinforces the vital contribution SBA makes to small businesses and the American economy overall," Velázquez said. "But I am concerned about the proposed underfunding of several programs and the ongoing 7(a) subsidy rate issue that essentially taxes small businesses. I hope that we can work together to reexamine our priorities for the SBA and rework the 7(a) subsidy rate so that small companies and entrepreneurs get the help they need in these uncertain times."

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Stephanie Tubbs Jones
Congress of the United States
11th District, Ohio

Stephanie Tubbs Jones

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Congresswoman Stephanie Tubbs Jones
Statement On The Small Business Budget

Access To Capital and BusinessLINC

Committee on Small Business
February 13, 2002

Mr. Chairman, Ranking Member Velazquez, and Guests:

In speaking with many small businesses in my community, the Eleventh District of Ohio, it is clear that access to capital and markets are factors that can affect success. The BusinessLINC program assists in developing business-to-business relationships in the private sector.

BusinessLINC is unique, in that it focuses on creating business-to-business relationships between large and small businesses, majority and minority firms. But the Administration has zeroed out this program this year, along with others that provide needed technical assistance.

Many of my constituents have conveyed their frustration at being left out of informal networks that form the basis for later business dealings. By extension, this has a negative effect on the economy - both locally and nationally. This is why I support BusinessLINC.

Access to capital is a primary need for small business. In my district just this week, I had an opportunity to speak with a business leader about financing small businesses.

Over the past few years, banks in my community have decreased lending to minority small businesses through the Small Business Administration's guaranty programs. Last year for all loans, lending decreased from 808 to 771 loans made, a decrease of 4.5 percent. Among minority businesses, lending decreased from 118 in the year 2000, to 93 in 2001, a decrease of 21 percent. Why has lending declined so much faster for minority businesses?

There are a lot of reasons bankers might suggest, including the economy. However, I submit that part of the problem lies in the banks' willingness to offer and service small loans. In a poor economy, access to capital is particularly important because it can make the difference between staying afloat or closing down.

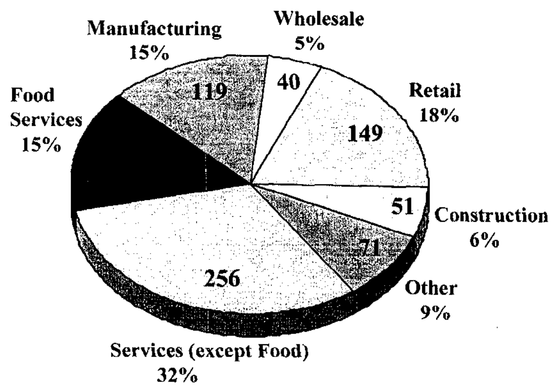
For this reason, I offered an amendment to extend participation in the 7(a) loan program to member-based credit unions. This action is permitted under a 1976 opinion of the SBA General Counsel. This committee passed that amendment favorably. Eleven members and I also asked the Small Business Administration to take action on this issue administratively but we have not received a response to this request.

It is my hope that your office will examine this issue and respond. America's small businesses can't afford to wait.

Overall Loan Distribution

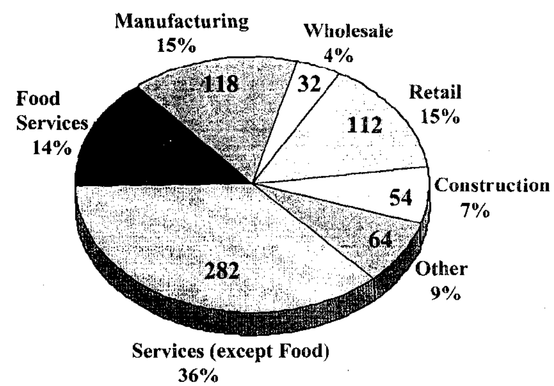
Loan Numbers by Industry
Cleveland District Office

FY 2000



Total Loans - 808

FY 2001



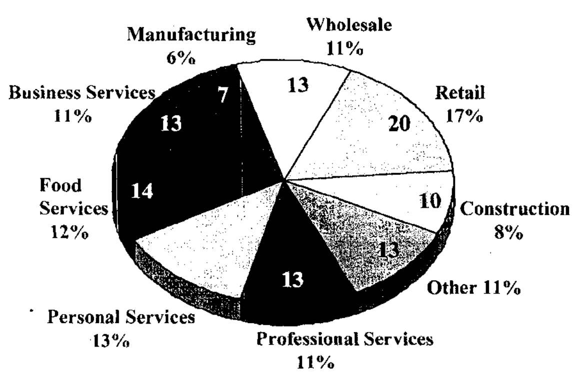
Total Loans - 771

Minority Loan Distribution

Number of Loans by Industry

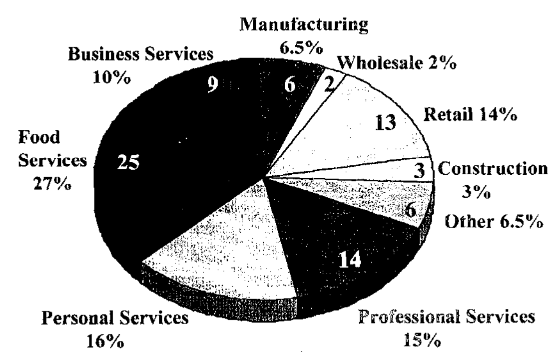
Cleveland District Office

FY 2000



Total Minority Loans - 118*

FY 2001



Total Minority Loans - 93*

* - does not include microloans

Jim Langevin

JAMES R. LANGEVIN
2D DISTRICT, RHODE ISLAND

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The Honorable James Langevin

STATEMENT BEFORE THE HOUSE SMALL BUSINESS COMMITTEE REGARDING THE SMALL BUSINESS ADMINISTRATION'S FY2003 BUDGET SUBMISSION
February 13, 2002

Mr. Chairman, I appreciate you holding this hearing, as I have strong reservations about portions of the Administration's FY 2003 budget request for the Small Business Administration. While this proposal increases overall funding levels from last year's SBA budget, there are several programs critical to the small business community that have been inadequately funded and even eliminated.

In particular, the Administration's request would cut the 7(a) loan program in half. By providing loan guarantees to eligible small businesses that would otherwise be unable to secure financing, 7(a) loans fill the gap left by traditional private lenders and supply necessary capital for America's small businesses to expand and create jobs.

In 2001, this crucial program backed 43,000 loans worth over $9.9 billion to small firms nationwide. Last year, 27 different financial institutions in Rhode Island approved 961 7(a) loans for a total of over $94 million to Rhode Island's small business community. In fact, 7(a) loans make up nearly one-third of all long-term loans made to U.S. small businesses. This program is important to every small business in America, and it deserves our continued support.

Additionally, the Administration continues to overestimate the credit subsidy cost of the 7(a) loan program, forcing both borrowers and lenders to pay unnecessarily high fees. If these estimates were revised, the SBA could lower its fees and lenders could attract more business. Under the Administration's proposal, Rhode Island would only be able to process 50 percent of its 7(a) loan volume from the previous and current year thereby decreasing loan assistance for the state by $50 million. This would seriously affect the ability of small businesses to start and grow in Rhode Island, and hamper recovery in the current economic climate.

The New Market Venture Capital Program designed to spur investment in low-and moderate-income communities and passed with overwhelming bipartisan support last Congress, has been zeroed out in this year's proposal. Funding for the PRIME program, which allows SBA to award grants to non-profit micro-enterprise development organizations, has also been eliminated. Finally, BusinessLinc, which grants funding to local non-profit economic development organizations to assist them in bringing local businesses to the attention of large corporations, has been underfunded to the point that the program will effectively no longer exist. Discontinuing these vital programs will negatively affect economic development initiatives targeted to low-income and minority business communities. When an economic downturn is threatening businesses, jobs and families across the country, these kinds of cuts pose more danger than ever.

Mr. Chairman, small businesses are the backbone of Rhode Island's economy and account for more than 98 percent of the jobs in the state. They bring new and innovative services and products to the marketplace and provide business ownership opportunities to diverse and traditionally underrepresented groups. Many of these small businesses rely on the valuable loan assistance, technical training and grant programs offered by the SBA. The Administration's harsh budget cuts would severely impact Rhode Island's small business community, just when we need their contributions the most. I would strongly urge the Administration to submit a proposal that sufficiently addresses the needs of the small business community, and I look forward to hearing more on these issues from our panel today. Thank you Mr. Chairman.

DONNA M. CHRISTENSEN
DELEGATE, VIRGIN ISLANDS

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STATEMENT OF CONGRESSWOMAN DONNA M. CHRISTENSEN
SMALL BUSINESS FULL COMMITTEE HEARING ON
PRESIDENT BUSH'S PROPOSED
U.S. SMALL BUSINESS ADMINISTRATION FY'O3 BUDGET

WEDNESDAY, FEBRUARY 13, 2002

Thank you Chairman Manzullo and Ranking Member Velazquez for holding this oversight hearing to review the Small Business Administration's Fiscal Year 2003 budget proposal. I want to especially thank Representative Velazquez for the work you led in this committee last year to improve on the FY 2002 budget so that it would be more responsive to the true needs of the small business community.

I would also like to take this opportunity to welcome Administrator Hector Barreto and the witnesses on the second panel to today's hearing.

The Small Business Administration FY 2003 budget proposal is far more promising than that of FY 2002. I am pleased to see that the Small Business Administration's FY 2003 budget request of $800 million represents a $258 million increase from last year's budget request, and does not include proposals to assess fees on the 7(a) program and Small Business Development Centers that constituted a major portion of last year's budget. We are off then to a better start this year.

However, while the SBA FY 2003 budget proposal has its strong points, there are areas that are still of concern to me and the other members of this committee.

I question the level of funding requested for the 7(a) guaranteed business loan program – the largest SBA lending program. The budget request of $85 million is an improvement compared to last year's proposal to replace direct funding of the 7(a) program with fee increases. While a drastic improvement, $85 million appears to be a low figure depending on whether there will be a $22 million carryover from last year, as SBA has projected. It is estimated that the lending rate has dropped to $500 million from $800 million. The decrease in funding request for the 7(a) program coupled with the

Statement of Congresswoman Donna Christensen
Small Business Full Committee Hearing
02/13/02

possibility of an SBA increase in the subsidy rate for the program does not create a fertile ground for more lending. Now, more than ever before, especially in the wake of September 11^{th}, the SBA 7(a) program plays a key role in providing long-term credit for small businesses. The 7(a) guarantee program is even more critical since the Federal Reserve Board is reporting that banks have tightened its standards for granting business loans. It is just simply becoming increasingly difficult for small businesses to obtain loans from commercial institutions, thereby increasing the need for more 7(a) loans.

On an issue that is of great importance to my district, since Congress has not passed a Small Business Relief bill, the SBA Disaster Loan has become the a primary source of economic and disaster relief for small businesses by providing millions of dollars to thousands of business owners affected by terrorist attacks of September 11^{th}. Prior to September 11^{th}, the Disaster Loan Program provided relief to businesses affected by disasters such as hurricanes, earthquakes, and other natural disasters. Much to the dismay of some business owners, the economic relief provided by obtaining disaster loan assistance turned into yet another disaster when their loans were included in the SBA Asset Sales and they become subject to commercial standards which provides less flexibility than SBA in negotiating payment options. The President's FY 2003 budget calls for $800 million in authority for the Disaster Loan Program. This is important, but also just as important as the level of this funding request, is the affect that sale of disaster loans have on the borrowers. I have written to Administrator Barreto on this issue and Mr. Chairman, I take; this opportunity to remind you that last year I made a request for a full committee hearing on this issue, and you agreed. To make this hearing meaningful, for my district, which has serious concerns about this issue, it would be best held there.

Another area of concern is the funding of SBA programs that reach out to low and moderate-income communities. BusinessLINC, which is part of the New Markets Initiative, is a very essential program designed assist businesses grow through a mentor-protégé relationship by linking small businesses with larger businesses. It is true that there are numerous partnerships across the nation that are similar to BusinessLINC, however a federally sponsored program would make such a program accessible to more businesses.

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The President's proposed SBA budget, as it stands, would zero out funding for the loan guarantee and technical assistance components of the New Markets Venture Capital Company program. This is especially important since SBA has not requested direct funding for the Small Business Investment Company Program.

The Women's Business Center is a program that is critical in assisting the fast growing segment of the business community- women owned businesses. This program still remains funded below its authorized level of $14 million. Some Women Business Centers are wondering whether they will be able to provide sustainability grants, which would allow the program to continue once their funding expires.

It is estimated that e-commerce sales will grow to $3 trillion by 2003. However, there are still significant obstacles to small business participation in e-commerce and keeping up with technological advances. Cost and technical skills continue to be significant barriers for small businesses. There is certainly a need for more funding to provide this greatly needed technical assistance to small businesses. Small Businesses simply do not have the capital to meet the demands of today's advancing and rapidly changing technology.

Although the SBA proposed budget for FY 2003 is more promising than that of last year and I commend Administrator Hector Barreto for his leadership since his appointment to this position despite being face with unprecedented challenges just in his first year. However, I would encourage SBA to take a closer look at their budget proposal and reconsider requesting funding or higher levels of funding for programs such as BusinessLINC, which never had a chance to get off the ground, the Women's Business Center, the 7(a) program and the SBDCs. Whereas, I congratulate the SBA on its 50th Anniversary, I do could not endorse a $1.5 million celebration at this time.

Thank you and I look forward to your testimonies.

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Congressman Tom Udall
3rd Congressional District of New Mexico
Small Business Committee
Hearing—Small Business FY03 Budget
2/13/02

Chairman Manzullo and Ranking Member Velasquez:

Thank you for holding this hearing today to review the Small Business Administration's (SBA) budget submission for FY03. I would also like to thank Administrator Barreto and the other members of the panel for coming before the committee today. I look forward to hearing testimony from all of you.

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I am very pleased to see that the Budget request for FY03 is a $258 million increase of the SBA's FY02 budget, but I do have some concerns about lack of funding for various important programs because they are believed to be "duplicative." Programs such as the New Markets Venture Capital Program, BusinessLinc, and PRIME have all been unfunded for the second year in a row. These proposals will severely limit access to capital for small businesses, especially those owned by women, minorities and entrepreneurs located in low income areas.

This is particularly troubling to me given the breakdown of my district. The 3rd Congressional District of New Mexico, which I have the honor of representing, has a high percentage of minorities, including Native Americans and Hispanics. In addition, I also represent many low-income areas. Therefore, the fact that these programs received no funding in the FY03 SBA budget has a severe, negative impact on my district.

Moreover, although I am pleased to see $85 million for the 7(a) loan program included in the budget, I am concerned about discussions surrounding a doubling of the subsidy rate for the 7(a) program. Doubling the subsidy rate would result in cutting the program in half and deprive borrowers of almost half a billion in capital.

Despite my concerns, Administrator Barreto, and members of the panel, I thank you for your work on this budget and look forward to working with you and my colleagues on the Committee to remedy what I believe are shortfalls in the SBA budget for FY03.

Again, thank you members of the panel, and thank you Mr. Chairman for allowing me the opportunity to offer my remarks.

STATEMENT OF

HECTOR BARRETO
ADMINISTRATOR

U.S. SMALL BUSINESS ADMINISTRATION

SBA'S FISCAL YEAR 2003 BUDGET REQUEST

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 13, 2002

Mr. Chairman, Ranking Member Velazquez, and members of the Committee, thank you for inviting me here today to discuss the President's Budget Request for the U.S. Small Business Administration (SBA) for Fiscal Year (FY) 2003. To paraphrase President Bush, there are no Democratic solutions to small business issues, nor are there Republican solutions. There are only *solutions*. Year after year, the Members of the House Committee on Small Business have recognized this and have consistently reached consensus instead of conflict. America's small businesses are better off today as a result of your working together.

I know we can continue that tradition. It is in this spirit that I respectfully ask for your support of the President's Budget Request of $798 million for the SBA. The President has increased our budget to provide more than $17 billion in capital and technical assistance to small businesses and disaster victims so that the SBA may continue making services available to those of our Nation's 25 million small businesses which need them most. This budget reflects the President's commitment to economic security through its support of small businesses and their creation of new jobs.

Before we continue our discussion on FY 2003, please permit me to take this opportunity to commend the many federal disaster relief workers for their role after the attacks of September 11. In the immediate aftermath of this unprecedented attack on American soil, the SBA mobilized both its disaster and district office employees, including its resource partners, to open some 40 temporary disaster assistance offices in New York City and Virginia.

Through the dedication of SBA employees, we have delivered as of February 11 more than $458 million in disaster loans nationwide – $271 million in disaster loans in New York, $9.5 million in Virginia and $177 million elsewhere. I am pleased to say that the SBA was on-site very quickly after the attacks and in many cases canvassed areas door-to-door south of Canal Street and beyond, distributing disaster loan applications to small business owners. These dedicated men and women of the SBA have worked tirelessly to distribute applications, answer questions, verify damages, and process and disburse loans. Placing the success of the mission above any personal consideration, the SBA family continues to work long hours without seeking recognition for their tremendous efforts. The SBA also rolled out an unprecedented nationwide expansion of the Economic Injury Disaster Loans (EIDL) Program to help those small businesses across the country adversely affected by the events of September 11. I am proud to lead an Agency that employs such loyal, dedicated and caring employees. I know that you join me in this sentiment and share our commitment to continuing this important work on behalf of impacted small businessmen and women across the country.

Disaster assistance, however, is but one of many ways through which the SBA reaches its customers. The 2003 budget includes specific requests for the following programs, a few of which I will highlight in greater detail later in my testimony:

- $4.85 billion in program level, through an appropriation of $85.360 million, for the 7(a) Loan Guaranty Program;
- $4.5 billion in program level, without taxpayer subsidy, for the 504 Certified Development Company Program;
- $7 billion in program level, without taxpayer subsidy, for the Small Business Investment Company (SBIC) Program;

- $1.67 billion in program level, without taxpayer subsidy, for the Surety Bond Guarantee Program;
- $26.6 million in program level, through an appropriation of $3.726 million, for the Microloan Direct Program.
- $17.5 million for Microloan technical assistance;
- $795 million for disaster relief;
- $1.1 million for Advocacy Database and Analysis;
- $500,000 for Ombudsman and Regulatory Fairness Boards;
- $750,000 for Veteran's Outreach;
- $1.5 million for initial preparation for a National Conference on Small Business;
- $3.6 million for 7(j) technical assistance;
- $500,000 for the Pro-Net Small Business Database;
- $500,000 for Small Business Innovation Research (SBIR) Program technical assistance;
- $3 million for the Federal and State Technology (FAST) Program;
- $2 million for the HUBZone program;
- $88 million for Small Business Development Centers (SBDC) grants;
- $3 million for the Paul D. Coverdell Drug-Free Workplace Program;
- $5 million for the Service Corps of Retired Executives (SCORE);
- $475,000 for Business Information Centers (BICs);
- $12 million for Women's Business Centers (WBCs);
- $750,000 for the Women's Council;
- $1 million for Native American outreach; and
- $3.1 million for United States Export Assistance Centers (USEACs).

Our budget request will allow us to continue meeting demand for the 7(a) Loan Guaranty Program, the flagship program of the SBA, through FY 2003, and we are working on ways to improve the program to ensure we can meet demand in future years. Let me further elaborate.

In FY 2003, for the first time in many years, the SBA and the Office of Management and Budget (OMB) worked to make the subsidy rate calculation method more accurately reflect changes in the program. In furtherance of that goal, we have contracted with the Office of Federal Housing Enterprise Oversight (OFHEO) to create an econometric model for the subsidy rate for FY 2004. In the interim, our calculation for FY 2003, which weights Preferred Lender loans in proportion to participation in the program, produced a subsidy rate estimate of .88 percent – a 20 percent decrease. With the requested appropriation of $85.36 million for FY 2003, this would have resulted in a 9 percent increase in loan volume, producing a record level of loan authority. However, P.L. 107-100 subsequently reduced the fees paid by borrowers and lenders for a two-year period beginning in FY 2003, resulting in a doubled subsidy rate of 1.76 percent and a 7(a) program level of $4.85 billion.

While this statutory change poses a significant challenge to the SBA in satisfying increasing loan demand, we believe that other recent legislation will help us meet this demand. The combined budget authority for the 7(a) program in FY 2002 is $175 million. This figure includes the SBA's annual appropriation of $78 million, the supplemental appropriation of $75 million, and carryover from FY 2001 of $22 million. While the supplemental 7(a) program is executed at an different subsidy rate than the regular program (1.67 percent versus 1.07 percent, respectively), the total 7(a) loan guaranty authority for FY 2002 comes to $13.84 billion. Adding this amount to the FY 2003 program level of $4.85 billion produces a two-year program level of $18.69 billion, or an annual average of $9.34 billion, which is consistent with historical levels. In FY 2003, we anticipate converting approximately $3.3 billion in guaranty authority from FY 2002 into $2 billion in guaranty authority under the subsidy rate created by P.L. 107-100. This would support a nearly $7 billion program level in FY 2003.

The current challenge creates an opportunity to examine the 7(a) program to ensure its continued relevance in the current marketplace for both lenders and borrowers. One of our concerns is the relationship between the 7(a) program and the 504 Certified Development Company. 7(a) and 504 in some ways compete with each other instead of complementing one another. The 504 program, formed specifically for job creation, provides financing for real estate and major fixed assets. We have determined that the 504 program is not reaching its full potential. For example, over 40 percent of loans provided under 7(a) are large real estate loans, many of which 504 could easily accommodate.

Steering those larger real estate loans to 504 will assist our goal of reducing the average 7(a) loan size from roughly $244,000 per loan to a more desirable average of around $175,000. Our aim is to increase the proportion of smaller loans, the type of loans often the most difficult for small businesses to receive. We are looking at ways to encourage lenders to make smaller loans.

Doing so will enable us to better provide loans to small businesses – the businesses that represent 99 percent of all employers and 52 percent of the private workforce. An *Inc* 500 study has shown that a majority of the fastest growing companies started with less than $50,000 in capital. Reducing the average loan size in the 7(a) program will make the SBA an even greater engine in creating jobs and providing for the nation's economic security. We are confident that our lending partners will work with us to ensure that more businesses which need 7(a) assistance will be able to receive it.

As I said before, the 504 program provides financing for major fixed assets. Its statutory purposes are to foster economic development and to create or preserve job opportunities by providing long-term financing for small business concerns. The program will provide up to $4.5 billion in lending in FY 2003, up from a lending volume of $2.3 billion in FY 2001. This renewed emphasis on 504 allows the SBA to support a significantly higher number of the larger loans critical to the success of small businesses needing financing for real estate and long-term capital equipment purchases. This program has not required a subsidy from taxpayers since FY 1996, as an on-going fee paid by small business borrowers fully funds it. We propose to slightly adjust this fee in FY 2003 from .410% to .425% to allow the program to continue without taxpayer subsidy.

As with 7(a), we have contracted with OFHEO to create an econometric model for the 504 program's subsidy rate. We will implement the results in FY 2005, a year later than implementation for the 7(a) subsidy rate, to give us time to evaluate the results of using this model on the 7(a) program before using it in additional programs.

As we attempt to implement these and other reforms to our finance programs, we will work closely with you in Congress to ensure that these programs retain their crucial role in assisting small businesses.

In keeping with the President's management goals, we are restructuring the workforce at the SBA. We are investing in the workforce now to produce future savings. This agenda includes increasing telecommuting, consolidating servicing contracts to reduce overhead and rent and improving productivity through the use of technology.

Managing for results – working with partners to ensure the effectiveness of programs – is another of the President's management goals. I have taken steps to deal with the management issues raised by the General Accounting Office and the Inspector General. We have also addresses the President's E-Government initiative to create a government that is more citizen-centered. The budget request includes $5 million for SBA's leadership role in the Federal Government's interagency effort to build a website that reduces the burden of wading through laws and regulations. Small business owners have a labyrinth of laws and regulations to negotiate on the Federal, state and local levels and no guide to assist them in determining which are applicable. This Business Compliance One-Stop on the Internet will build upon BusinessLaw.gov, which the SBA has already implemented, and will provide those small business owners simpler, 24/7 access to the vital information they need to run their businesses.

Additionally, in order to ensure security of its computer systems and to provide small businesses the access described above, the budget request includes $2.8 million to support SBA's upgrade of its information technology infrastructure. The SBA will also begin implementation of an e-documents management system to assist with the retention and administration of the SBA's electronic records. The budget request includes $750,000 for that purpose.

This budget request includes $1 million for the new Native American Economic Development Program, an initiative to establish partnerships with tribes engaged in economic development activity. According to the 2000 Census, there are over 2.5 million Native Americans and Alaskan and Hawaiian Natives, and the average unemployment rate on reservations in 1999 was 43 percent. The SBA is dedicated to ensuring that all Native Americans who seek to create, develop and expand small businesses have full access to the necessary business development and expansion tools available through Agency programs. This program is a comprehensive initiative designed to meet specific cultural needs and to result in small business creation. This initiative will make funding directly available to tribes to assist in economic development and job creation.

In addition to our initiative to assist Native Americans, the SBA operates two complementary programs to serve businesses which face difficulties due to particular economic and social reasons or geographic locations. The 8(a) Business Development Program assists the development of small companies owned and operated by socially and economically disadvantaged individuals. Eligible companies may be awarded set-aside federal contracts and other business development assistance. The number of contracting opportunities for small businesses has declined overall, including for 8(a). In response to that disturbing trend and to other concerns about the program, I ordered a review. While we have not completed that review, I can tell you that we will continue to work on ways to streamline the process required of applicants and to increase our efforts to obtain contract assistance for the program. We are also looking at ways to better define the individual needs of individual 8(a) firms and to increase their access to technical assistance and procurement opportunities.

Many 8(a) companies are located in areas designated as HUBZones (Historically Underutilized Business Zones) by the SBA's program which encourages economic development in distressed areas through federal contract award preferences for qualified small businesses located in such areas. Procuring agencies have not used this program to the extent possible. We are looking at a variety of ways to increase the federal contracts that these businesses receive as well as increasing their private sector contracting opportunities.

It is our goal to treat the 8(a) and HUBZone programs equally and not as competitors. I believe that they are both powerful tools that will help the federal government meet and exceed its small business contracting goals.

The SBA will also be implementing the President's management agenda, an agenda that includes restructuring our workforce, increasing the use of competitive sourcing, expanding use of technology and managing for results. Part of our operating expenses will increase as a result of shifting $18 million in pension and health benefits that were previously part of the Office of Personnel Management's budget.

The Loan Monitoring System (LMS) will allow us to do on-line monitoring of our lending partners. The SBA has contracted with KPMG to review the planning steps taken to ensure compliance with the law and remain consistent with the project parameters. In March we will receive a detailed outline of options. These options will allow the SBA to implement various modules, depending on cost benefit. Currently the vast majority of our oversight is done through on-site reviews of our lending partners and contracted audits for the Small Business Lending Companies.

SBA has taken steps to strengthen and institutionalize its "Information Technology [IT] Planning and Investment Control Process" to improve selection and control of IT projects in a portfolio environment and to improve formulation of the IT budget. Doing so will help the SBA meet the requirements of the Clinger-Cohen Information Technology Management Reform Act.

I want to briefly discuss two programs which we do not plan to fund in FY 2003. The Program for Investment in Microentrepreneurs (PRIME) mirrors the existing Microloan technical assistance program. We cannot justify funding two nearly identical programs. Our Microloan intermediaries and our non-loan technical assistance providers already offer a full range of services for prospective microloan borrowers and microentrepreneurs. Their resources combined with the array of other programs such as WBCs and SBDCs will fully meet the needs of microentrepreneurs.

The Business Learning, Innovation, Networking and Collaboration (BusinessLINC) Program replicates other existing SBA technical assistance programs that foster mentor-protégé relationships, as well as programs at NASA and the Department of Defense. BusinessLINC also duplicates SBA's 7(j) management and technical assistance program, which provides contract grants and cooperative agreements to organizations that provide direct assistance to small and emerging businesses. Finally, BusinessLINC was designed to provide small businesses with an online information source and database of companies interested in mentor-protégé programs. We can achieve those goals through existing BICs, WBCs and PRO-Net, as well as through the private sector.

The SBA will celebrate its 50th anniversary in July 2003. In its half-century in existence, the SBA has assisted hundreds of thousands of businesses in their formative stages. Many of those companies have names with which all of you here are quite familiar – names like Federal Express, Intel and Nike, to name just three.

We are working hard at the SBA to make certain that the Agency retains its leadership position as it looks forward to another half-century and will continue to provide crucial assistance to the next Federal Express or the next Intel. As I have taken a close look at our programs and services throughout my first year as Administrator, I have seen what the SBA can do and what the SBA needs to do to keep its programs in tune with the ever-changing economy.

We cannot do this alone. I know that I have spoken with some of you individually, but I want to take this opportunity while we are all together to enroll you in these efforts.

As I mentioned at the beginning of my testimony, the SBA's FY 2003 request is a good one for small businesses and offers a beginning point for us to work in tandem with our partners in Congress to ensure that the SBA remains an effective, relevant agency that provides twenty-first century service for the small business community's needs. We ask for your support for this budget. Thank you for the opportunity to appear here today. I will be happy to answer your questions.

NAGGL

The Answers You Trust
The Training You Expect
The Voice You Need

Testimony for the House Committee on Small Business

submitted by

Anthony R. Wilkinson,
President and Chief Executive Officer

The National Association of
Government Guaranteed Lenders, Inc.

P.O. Box 332
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Wednesday, February 13, 2002

SBA 7(a) Program

Re-estimates Compared to Appropriations

$ in millions

Year	Re-estimate $	Appropriation $
1995	59	213
1996	-100	78
1997	-277	173
1998	-647	197
1999	-176	134
2000	-117	114
2001	-164	107
2002	n/a	* 153
Totals	-$1,422	$1,169

*includes the $75 million in the FY 2002 Department of Defense appropriations bill for STAR loans.

Note: The bulk of the re-estimates are for loan cohorts FY 1992-1999. ***Total downward re-estimates will continue to increase.*** Loan cohorts 2000 through 2002 used default estimates well above actual performance. The downward re-estimates, for these loan cohorts, will be not be recognized by OMB until these cohorts move past peak defaults (year 3). Even so, ***the cumulative subsidy budget outlays for the SBA 7(a) program since 1995 total - $253 million.*** This means the 7(a) program has been run at a profit to the government, and that the amounts appropriated by Congress, for credit subsidies, have not been spent for that purpose.

The 2002 re-estimate will be made after the close of the fiscal year.

The National Association of Government Guaranteed Lenders, Inc. ("NAGGL") is a trade association for lenders and other participants who make approximately 80 percent of the Small Business Administration ("SBA") section 7(a) guaranteed loans. The SBA's 7(a) guaranteed loan program has proven to be an excellent public/private partnership. Over the last decade, the SBA has approved more than 424,000 loans for over $90 billion. We thank the Committee for the opportunity to comment on the SBA 7(a) program.

Since the beginning of "Credit Reform" in 1992, the SBA 7(a) subsidy rate has fallen from a high of 5.21 to the current services level for FY 2002 of 1.07. This represents an 80% reduction in the estimated cost of the program to the government. This reduction in subsidy costs has been achieved by improved underwriting guidelines, establishment of lender review procedures, and fee increases on both borrowers and lenders.

There are many positive attributes of the SBA 7(a) loan program, including:

- SBA loan programs provide approximately 40% of all long-term loans (loans with maturities of three years or longer) to small businesses. The SBA is the largest single provider of long-term loans to small business. This is contrary to the Administration budget that claims SBA provides only 1% of annual small business lending.

- SBA 7(a) loans have significantly longer maturities than conventional loans to small businesses. The average original maturity of SBA 7(a) loans, according to the Office of Management and Budget ("OMB"), is 14 years. By comparison, only 16% of conventional small business loans have maturities in excess of one year, and of those loans, the average maturity is less than four years

- Longer maturities mean substantially lower monthly payments for borrowers. For example, the difference in monthly payments from a 10 year SBA 7(a) loan to a five year conventional loan (which would be above the average maturity for conventional loans), would be 35-40%. This is a significant increase for the average SBA borrower who tends to be a new business startup or an early stage company.

- Small businesses do not have the same access to debt-capital as do large businesses. The SBA programs bridge that capital gap. Banks should not be expected to make long-term loans, the kind most needed by small business, when banks are funded by a short-term deposit base.

- The SBA 7(a) appropriations are leveraged almost 99 to 1 by the private sector, making this one of the governments' best economic development instruments. With a more accurate subsidy rate estimate (as discussed below), the leverage ratio would be even higher.

- The SBA 7(a) loan program is just that – a loan program – which helps qualified small businesses obtain the long-term loans they need for growth and expansion. This means jobs, and a "net return on investment" for our local communities and the US Treasury.

Unfortunately, the Administration's budget request for FY 2003 for the SBA 7(a) loan program does not adequately address the needs of small businesses of this nation. The Administration proposes to reduce the 7(a) program by more than half at a time when these kinds of loans are especially needed. The Administration also continues to use an overly-conservative, unjustifiable default assumption in the subsidy model that leads to a subsidy rate that over-estimates the cost of the program. The results are fees that are higher than necessary for borrowers and lenders, and an inefficient appropriations process.

In testimony before the House Small Business Committee in 2000, the former SBA Administrator testified "the program is already being run at a profit to the government." At that same House Small Business Committee hearing, a representative of SBA's CFO's (Chief Financial Officer) office testified that the default rate for the SBA 7(a) loan program was being managed "in the 8%-10% range." Yet OMB requires the use of an almost 13% default rate in the subsidy rate calculation. Each 1% reduction in the default estimate would reduce the subsidy rate by approximately 34 basis points, or .34. If the highest SBA default estimate of 10% (per the House testimony in 2000) were used, the projected current services subsidy rate of 1.76% for FY 2003 would be reduced by approximately 90 basis points. This would mean that OMB has calculated a subsidy rate that will prove to be more than twice the actual cost of the program.

Senate Roundtable on the 7(a) Loan Guaranty Program

On September 5, 2001, the Senate Small Business Committee held a roundtable discussion on the subsidy calculation of the SBA 7(a) program. Prior to the hearing, the GAO (General Accounting Office) issued a report indicating that OMB had overestimated defaults in the 7(a) program by more than $2 billion. GAO also said that SBA had submitted a proposal to OMB that would change the basis for the 7(a) program default estimate "in order to more closely track with actual loan performance in the future." The SBA recommended using a "five year lookback period" on default data, and this would have resulted in a default estimate of 9.74% (in the 8% to 10% range that was provided in the SBA CFO testimony), and a subsidy rate of –0.40% for FY 2002. OMB rejected the SBA proposal. OMB required a 1.07% subsidy estimate for FY 2002.

GAO also provided other default estimate scenarios. One was to look at all default history since the implementation of the Federal Credit Reform Act (post-1991 loans). This approach would have yielded a default estimate of 8.81% (again in the 8% to 10% range that was provided in the SBA CFO testimony), and would have resulted in a –0.54% for FY 2002. OMB rejected this approach.

The transcript of the proceedings, from the September 5, 2001 roundtable, provides some interesting information. John Whitmore, then the Acting Administrator and now the Chief of Staff, told the Senate panel:

> "I can assure you there is a new era of cooperation with this Administration that wants to work collaboratively with the Congress and our industry partners to ensure that all small businesses have access to our loan programs."

We are regretful that the only substantive discussion this association has had with SBA since then was a briefing on the FY 2003 budget request.

Dr. Lloyd Blanchard, then the Associate Director, General Government Programs, Office of Management and Budget, and now the Chief Operating Officer at SBA, told the Senate panel:

> "The history of this program is one that has had an unfortunate one. The Administration is working in its first year to correct this problem, and it is one that we inherited, that, as you all have mentioned, is a serious problem...We recognize that over the past 10-12 years there is a cumulative $2 billion that has gone back to Treasury."

We appreciated Dr Blanchard's comments, but with the release of the FY 2003 budget request, it was clear that OMB did not correct the subsidy problems. To hit the target OMB default rate, repurchased loans would have to increase by 30% to 50%.

Dr. Blanchard also said, in response to a comment from Senator Bennett (R-UT) who likened the subsidy calculation to a tax:

> "The purpose of the calculation is to predict the credit subsidy rate that not only shares the risk among the government and the borrowers and lenders, but also creates a self-financing program."

It is clear that this is how OMB has calculated the 7(a) subsidy rate. But the Federal Credit Reform Act of 1990 provides different reasons for the calculation. One purpose is to "measure accurately the costs of Federal credit programs. According to the Act, the cost of a loan guarantee "shall be the net present value, at the time when the guaranteed loan is disbursed, of the (i) payments by the Government to cover defaults and delinquencies, interest subsidies, or other payments; and (ii) payments to the Government including origination and other fees, penalties and recoveries." The Act DOES NOT GIVE OMB THE AUTHORITY TO UNILATERALY ADD AN ADDITIONAL AMOUNT SO THE PROGRAMS ARE "SELF-FINANCING." Yet that is exactly what OMB has done.

Another stated purpose of the Federal Credit Reform Act is to "improve the allocation of resources among credit program and between credit and other spending programs." OMB has clearly failed in this regard as the appropriation process for the 7(a) program, as a result of their unreasonable subsidy calculation, is very inefficient. As the opening table of this testimony shows, on a cumulative basis since 1995, every dollar appropriated for credit subsidies plus another $253 million has been returned to Treasury. This means OMB HAS DISREGARDED THE ANNUAL APPROPRIATIONS PROVISIONS AND USED THE MONEY FOR OTHER PURPOSES.

Treasury-Postal Appropriations

In the Treasury-Postal appropriation bill for the FY 2002, the conferees included report language stating they were concerned that borrowers and lenders have been paying fees much higher than necessary for the SBA 7(a) and 504 loan programs. The conferees stated that "this is the direct result of the fact that the subsidy rate model developed to determine a program's subsidy rate uses default assumptions that do not reflect recent program performance of either the 7(a) program or the 504 program, or the legislative and administrative changes made to these programs in the 1990's."

The Administration issued a Statement of Administration Position (SAP) opposing the inclusion of this language in the Treasury-Postal appropriation bill. The Administration claims the provision "purports to mandate how subsidy estimates should be calculated for the SBA 7(a) General Business and 504 Certified Development Company loan programs." The Treasury-Postal language did not "mandate" how credit subsidies should be calculated, but rather states the subsidy estimates mad by OMB in the 7(a) and 504 program do not reflect actual performance, and need to be modified.

The conferees also directed OMB to report back to Senate and House Small Business, Budget and Appropriation committees, within 30 days of enactment of the Treasury-Postal appropriation bill, on new subsidy rate estimates being developed for inclusion in the President's FY 2003 budget request. It is our understanding that OMB did not comply with this requirement.

NAGGL Requests

Small businesses continue to need access to long-term capital. NAGGL requests your support of sufficient appropriations to fund a $12 billion 7(a) program for FY 2003. We believe loan volume will increase next year for a variety of reasons, including the passage of S. 1196, that reduces fees for 7(a) program participants effective October 1, 2002. The Administration's proposed program level of $4.85 billion is totally insufficient to meet borrower demand.

Next, NAGGL requests your continued efforts to force OMB to calculate a fair and reasonable 7(a) subsidy rate. NAGGL supports stronger language in the Treasury-Postal appropriation bill for FY 2003. It is clear to us that, until they are somehow held accountable for the decisions made, OMB will simply ignore the will of Congress, and will continue to overcharge SBA 7(a) borrowers and lenders.

Lastly, we request that the Small Business and Budget Committees hold a joint hearing to review OMB's implementation of the Federal Credit Reform Act. More than 100% of the dollars appropriated for the 7(a) program since 1995 have been returned to the Treasury. IT IS TIME FOR A SOLUTION!

GAO
Accountability * Integrity * Reliability

Implications of Proposed Changes

- In March 2001, SBA submitted a proposal to OMB[12] that discusses using 5 years or 3 years of the most recent actual loan performance - referred to as the lookback period[13] - as the basis for the 7(a) program default estimate in order to more closely track with actual loan performance in the future. SBA recommends the 5 year lookback period.
  - This proposal is based on SBA's analysis that showed that the most recent years of actuals are more predictive of near-term future loan performance, notwithstanding a sudden shift in the economy.

[12] In the past, SBA has proposed other methods to refine its default estimates to OMB. According to OMB, SBA has not provided acceptable support that the alternatives would provide better estimates.
[13] For example, under the 5 year lookback period, the 2002 cohort estimate of year one default activity would be based on the average actual first year defaults that occurred for the 1998 through 2000 cohorts and the second year default activity would be based on actual second year defaults that occurred for the 1995 through 1999 cohorts.

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GAO
Accountability * Integrity * Reliability

Implications of Proposed Changes

- The following table contrasts the impact of using the current approach, a 5 year lookback, and a 3 year lookback to estimate the subsidy cost of the fiscal year 2002 cohort.

Estimation Alternatives' Effect on Subsidy Rate and Appropriation for the Fiscal Year 2002 Cohort

	Default Rate	Subsidy Rate	Appropriation
Current Approach	13.87%	1.07%	$114,490,000
5 Year Lookback	9.74%	-0.40%	-$42,800,000
3 Year Lookback	8.97%	-0.61%	-$65,270,000

Source: GAO analysis based on SBA data.

Note: Estimated appropriation assumes that all other assumptions remain unchanged.

32

128-4160
MAGAZINE
WASHINGTON BUSINESS JOURNAL
Arlington, VA

Circ- 15,940
Weekly

NOVEMBER 22, 2001

684 P70

Another bungled policy

Small-business owners everywhere should be disgusted by the slowpokes at the federal Office of Management and Budget. The OMB has been watching the deterioration of the U.S. Small Business Administration's 7(a) loan program for some time now, but says there is nothing it can do before fiscal 2003.

The problem: high fees associated with the 7(a) program have made the loans less attractive to banks and borrowers alike. Hundreds of banks around the country have dropped out of the program, and loan volume for the program was down 6 percent in the last fiscal year alone.

The fees are intended to guard against defaults but are calculated based on default rates from the late 1980s, during the S&L crisis. This, even though default rates have declined sharply in recent years.

Worse, the 7(a) fees — $958 million since 1992 — don't even go to cover bad loans. They go into the general government trough to give Congress more money to spend. In short, they are not really fees at all — they are hidden taxes on emerging growth companies around the country.

OMB is working to lower the fees but says it can't do anything for at least another year. With the economy in recession and small business in need of capital, we deserve better from our government.

■ DALLAS BUSINESS JOURNAL

128 - 3425 MAGAZINE
SACRAMENTO BUSINESS JOURNAL
Sacramento, CA

Circ - 13,175
Weekly

NOVEMBER 2, 2001

Bacon's

SBA lenders blame lofty fees for dip in 7(a) loans

KENT HOOVER / WASHINGTON BUREAU CHIEF

The dollar volume of loans issued through the U.S. Small Business Administration's flagship 7(a) loan program fell 6 percent in fiscal 2001, but SBA lenders don't blame the weakening economy for the decline.

Instead, they say high fees make the government-guaranteed loans unattractive to both lenders and the small businesses that rely on the program.

"It's tough for me to market those loans," says John Brocato, president and CEO of New Orleans-based BizCapital, Louisiana's largest SBA lender.

Many lenders have dropped out of the SBA program over the past year, he says. In Louisiana, there were more than 100 SBA lenders a year ago; now there are 20.

The future of the 7(a) program is especially important to startups and early-stage companies, which often cannot find long-term loans with low monthly payments elsewhere.

Brocato and a half-dozen other lenders traveled to Washington, D.C., in September for a Senate Small Business and Entrepreneurship Committee roundtable, where they urged the Office of Management and Budget to allow the SBA to lower the subsidy rate for 7(a) loans. This would enable the SBA to reduce its loan fees.

Since fiscal 1992, the U.S. government has overestimated the credit subsidy cost of the 7(a) program by $958 million, according to the General Accounting Office. The subsidy rate is based on average loan default rates since 1986. Critics say this is an inaccurate gauge because default rates have dropped dramatically since 1990.

Instead of covering bad loans, the excess money went to the government's general fund and helped pay for unrelated programs.

"That's a tax on small business," says Anthony Wilkinson, president and CEO of the National Association of Government Guaranteed Lenders, a trade association representing SBA lenders.

OMB, however, says the subsidy rate cannot be changed this year because the Federal Credit Reform Act forces agencies like the SBA to follow the assumptions included in the president's budget.

Sean O'Keefe, deputy director of OMB, says the agency will change the credit subsidy rate for fiscal 2003 by giving more weight to loans made by preferred lenders, which account for 60 percent of all 7(a) loans and have much lower default rates. In fiscal 2004, the SBA will adopt an econometric model to predict loan performance.

OMB's decision disappointed the Senate Small Business and Entrepreneurship Committee and SBA lenders.

Brocato thinks the SBA "could have supported lenders more than they did" at the roundtable. "We're the ones who do all the work and put out the money," he says. "Without the lenders, there is no SBA."

While small-business lending as a whole typically declines during downturns, SBA lending usually is counter-cyclical. Since Sept. 11, for example, the SBA has approved more 7(a) loans than it did during the same period a year ago.

While 7(a) lending was down for fiscal 2001 as a whole, most of that decline occurred during the first half of the year. Since the end of July, demand for 7(a) loans has been increasing, says LeAnn Oliver, the SBA's deputy associate administrator for financial assistance.

But Brocato speculates that many of the 7(a) loans that have been approved since the Sept. 11 terrorist attacks were for small businesses that already had completed their loan packages. The impact of the attacks on SBA lending may not show up until the first quarter of 2002, when he expects the number of startups receiving 7(a) loans to drop.

Pending legislation would waive guarantee fees on 7(a) loans for one year as part of a relief package for small businesses hurt by the Sept. 11 attacks.

SBA 7(a) loan program

Continued from page 20

ness & Entrepreneurship Committee, and Sen. Kit Bond (R-Mo.) would waive guarantee fees on 7(a) loans for one year as part of a relief package for small businesses hurt by the Sept. 11 terrorist attacks on America.

"History has taught us that, during an economic downturn, lenders become increasingly reluctant to lend to small businesses," Kerry says. "From our contacts with lenders, we know loan committees decided days after the attacks to clamp down on loans to small businesses."

While small business lending as a whole typically declines during downturns, SBA lending tends to be countercyclical. Since Sept. 11, for example, the SBA has approved more 7(a) loans than it did during the same period a year ago.

NERVOUS LENDERS

"With uncertainties creeping up, lenders are getting a little more nervous and want our guarantee," says LeAnn Oliver, the SBA's deputy associate administrator for financial assistance.

While 7(a) lending was down for fiscal 2001 as a whole, most of that decline occurred during the first half of the year. Since the end of July, demand for 7(a) loans has been increasing, Oliver says.

But Brocato speculates that many of the 7(a) loans that have been approved since Sept. 11 were for small businesses that already had completed their loan packages. The impact of the attacks on SBA lending may not show up until the first quarter of 2002, when he expects the number of startups receiving 7(a) loans to drop.

"The real issue is that OMB is charging me and my clients too much money," Brocato says.

Kent Hoover is the Washington bureau chief for American City Business Journals.

SBA 7(A) LOAN VOLUME

FISCAL YEAR	NO. OF LOANS	AMOUNT
2001	42,957	$9.89 billion
2000	43,748	$10.52 billion
1999	43,639	$10.15 billion
1998	45,288	$9.46 billion
1997	42,268	$9.01 billion

Source: Small Business Administration

123-250 MAGAZINE
AUSTIN BUSINESS JOURNAL
Austin, TX

Circ- 5,232
Weekly

DECEMBER 20, 2001

Bacon's

EDITORIAL

SBA program needs boost

In difficult financial times, small businesses need access to program that lenders are shunning

Small business owners everywhere have good reason to be upset by the slowpokes at the federal Office of Management and Budget.

The OMB has been watching the deterioration of the U.S. Small Business Administration's 7(a) loan program for some time now, but says there is nothing that can be done before fiscal 2003.

The problem: High fees associated with the 7(a) program have made the loans less attractive to banks and borrowers alike. Hundreds of banks around the country have dropped out of the program, and loan volume for the program was down 6 percent in the last fiscal year alone.

Look at some Central Texas numbers. According to surveys by the *Austin Business Journal*, the top area lender in the program between October 1999 and September 2000 did \$20.59 million in loans. For the next year in the same time period, the top area lender did only \$9.64 million. In the earlier time period, the top three lenders in the program issued 106 loans. That slipped to 98 loans in 2000-2001.

The fees are intended to guard against defaults but are calculated based on default rates from the late 1980s, during the savings and loan crisis, which hit Texas especially hard. The fees remain in place even though default rates have declined sharply in recent years.

Worse, the 7(a) fees — \$958 million since 1992 — don't even go to cover bad loans. They go into the general government trough to give Congress more money to spend.

In short, they are not really fees at all; they are hidden taxes on emerging growth companies around the country.

SBA Administrator Hector Barreto spoke in Austin in late November explaining the SBA lending programs offered by the government.

When questioned by the Business Journal on the declining interest in the loan program, Barreto said the SBA is working to reduce the time it takes to process loans and educate companies about the program.

Barreto said top to bottom review is underway to determine ways to improve the program. But he could not say when the review would be complete or what areas he had already focused on for improvement.

It was the same type of bureaucratic "someday" answer coming out of the nation's capitol.

OMB is working to lower the fees but says it can't do anything for at least another year.

With the economy in recession and small business in need of capital, we deserve better from our government.

128 – 2840 MAGAZINE
NEW ORLEANS CITYBUSINESS
Metairie, LA

Circ – 15,030
Weekly

DECEMBER 10, 2001

684 P1

Lenders want easier-to-get business loans

By Ian McNulty *Staff Writer*

SCANDINAVIAN FURNITURE INC. looked recession in the eye and decided to expand anyway.

"We've been working toward this for many, many years. We are staying with what we planned," says Hans Thomsen, who owns the 19-year-old furniture store with his wife Patsy. The first part of an expansion to triple the size of his Clearview Parkway showroom and warehouse is already complete and construction on the second phase begins this week. "Business has been very good," Thomsen adds.

But getting the money to finance the deal wasn't easy. Even before recession was declared last month, lenders responded to the slower economy and regulatory pressure with tighter credit standards and stiffer terms on business loans.

What enabled Scandinavian Furniture to clinch its financing was a loan guarantee from the Small Business Administration. Through a vehicle called the 7(a) Loan Guaranty Program, the federal government agreed to insure $1 million of the company's new debt. Combined with a conventional bank mortgage, it was enough to finance the full cost of the expansion, an amount Thomsen would not specify.

See **BUSINESS LOANS,** *page 59* M

684 G

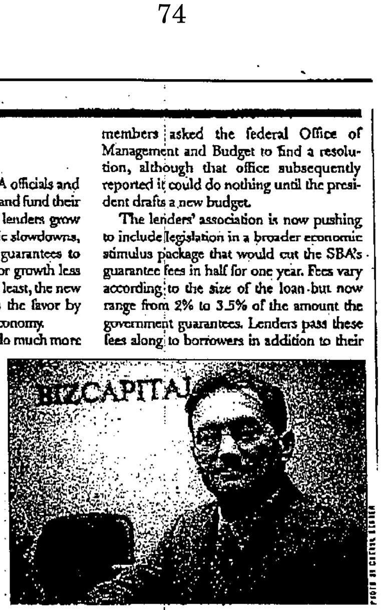
BUSINESS LOANS

continued from page 1

This is the kind of story SBA officials and the private lenders who market and fund their loan program like to hear. As lenders grow more cautious during economic slowdowns, more borrowers turn to 7(a) guarantees to make their plans for start-ups or growth less risky for financing. In theory at least, the new or expanded business returns the favor by creating jobs and stoking the economy.

But lenders say they could do much more if the program were restructured. The central issues are the size of the fees the government charges for the loan guarantee and the amount of coverage provided under the program. With lawmakers thinking about stimulus plans to rouse the nation's economy, some lenders say it's time to look at the structure and future of SBA loans.

To help fuel an economic rebound, lenders "need to have more coverage and fewer fees," says John Brocato, president of Metairie-based Biz Capital. "But the SBA is going another direction."



John Brocato, president of Metairie-based Biz Capital

Biz Capital, a subsidiary of New Orleans venture capital firm Advantage Capital Partners, led the state in SBA-approved loans in fiscal 2001, closing about $14.3 million in loans through the program. Biz Capital also became an SBA preferred lender earlier this year, meaning it can approve loans faster and with less paperwork while also assuming greater liability for its loans.

In September, Brocato joined nine other SBA lenders from around the nation in Washington, D.C., to meet with the Senate's Committee on Small Business and Entrepreneurship and stump for lower fees and greater loan coverage.

High cost of borrowing

The lenders' industry group, the National Association of Government Guaranteed Lenders, has argued the SBA's fees are based on inflated estimates of loan defaults and other program costs the fees are intended to cover. If these costs and loan failure predictions were revised, the SBA could lower its fees and lenders could attract more business, says Anthony Wilkinson, director of the Stillwater, Okla.-based association.

In August, investigators with the General Accounting Office found that during the nine years since 1992, the SBA overestimated loan defaults in the 7(a) program by $2 billion and overestimated the cost of running the program by $958 million.

Investigators blamed SBA's policy of predicting default rates based on figures dating back to 1986. But the GAO found actual default rates fell significantly after 1990 as a result of an improving economy and better underwriting standards. The report recommended the SBA use loan performance over the past five years to make default predictions and adjust fees to cover them.

"They tax small business and use the money somewhere else," Wilkinson says.

The Senate committee concurred and members asked the federal Office of Management and Budget to find a resolution, although that office subsequently reported it could do nothing until the president drafts a new budget.

The lenders' association is now pushing to include legislation in a broader economic stimulus package that would cut the SBA's guarantee fees in half for one year. Fees vary according to the size of the loan but now range from 2% to 3.5% of the amount the government guarantees. Lenders pass these fees along to borrowers in addition to their annual finance charges and any closing costs. The association also wants the SBA to boost its guarantees from 80% to 90% of the loan value for loans ~~over~~ $150,000 and from 75% to 85% for loans greater than $150,000.

under $150,000

Now more than ever

The SBA has been taking some of its own steps to make the loan guarantee program more accessible. Loretta Poree, an economic development specialist in the SBA's New Orleans office, says the agency has reduced the amount of paperwork it requires for loan approval over the past few years and can provide quicker approvals than ever. For loans under $150,000, the SBA can approve a loan within three days and as quickly as 36 hours, she says. For larger loans, approval time can take between five and 14 working days.

For the 2001 fiscal year, the New Orleans SBA office approved 518 loans for a total of $150 million, with 94% of these approved under the 7(a) program.

Some lenders say that loan amount would swell if fees were reduced and guarantees raised.

"The bottom line is, you lower the cost of capital and demand goes up," says Aaron Miscenich, New Orleans regional manager for Source Business & Industrial Development Corp., a lender based in Baton Rouge. The loan guarantee "is a product this economy needs. If you're going to spur economic development, you've got to make borrowing more attractive," he says.

Miscenich, who helped arrange the financing package for Scandinavian Furniture, says the fee structure can be a deal-breaker for some borrowers. But he also empathizes with the SBA's need to fund its guarantee obligations.

But even with its faults, Miscenich says, the loan guarantee has a potent ability to bring otherwise shaky financing deals to fruition by reducing lender risk. "It's incomparable in the marketplace," he says. •

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129 – 200 MAGAZINE
ATLANTA BUSINESS CHRONICLE
Atlanta, GA

Circ – 25,000
Weekly

DECEMBER 27, 2001

624 WASHINGTON BRIEFS 098

Congress cuts SBA loan fees — starting in October

Congress cut fees for the Small Business Administration's flagship 7(a) loans, but the reductions do not take effect until Oct. 1.

The loan fee reduction was added as an amendment to the Small Business Investment Company Act, which raised fees for the SBA's venture capital program. The Senate passed the legislation Dec. 7, and the House followed suit Dec. 11.

The bill calls for a two-year reduction in fees paid by both lenders and borrowers in the 7(a) program, a common source of working capital for start-ups and early-stage companies.

Fees charged to lenders were cut in half, from 0.5 percent to 0.25 percent of the outstanding balance of the SBA-guaranteed portion of the loan. Guaranty fees paid by borrowers were reduced from 2 percent to 1 percent for loans of less than $150,000, and from 3 percent to 2.5 percent for loans between $150,000 and $700,000.

Congress cut the fees in response to complaints that high fees made the 7(a) program unattractive to both banks and borrowers. In addition, a General Accounting Office study found the SBA had collected $958 million more in 7(a) fees than it needed to cover loan defaults since fiscal 1992.

Members of the House and Senate small-business committees tried to persuade the Office of Management and Budget to reduce the subsidy rate for the 7(a) program, which would have enabled the SBA to cut the fees this year, but OMB officials said it was too late in the budget process.

The bill also reduced fees for the SBA's 504 program, which offers long-term loans for real estate projects and equipment purchases.

Although the fee reductions do not go into effect until October, members of Congress hope they will encourage lending at a time when many banks are tightening credit to small businesses.

"This is just what the economy needs," said Rep. Nydia Velazquez, ranking Democrat on the House Small Business Committee.

The text of the Small Business Investment Company Act (SB 1196) is available at http://thomas.loc.gov.

United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510-6350

September 7, 2001

The Honorable Mitchell E. Daniels, Jr.
Director
Office of Management and Budget
Executive Office of the President
17th Street & Pennsylvania Avenue, N.W.
Washington, D.C. 20503

Dear Mitch:

On Wednesday, September 5, 2001, the Committee on Small Business and Entrepreneurship conducted a Roundtable on the credit subsidy rates for the Small Business Administration's (SBA) 7(a) guaranteed business loan program. The purpose of the Roundtable was to review a recent report from the General Accounting Office (GAO), which concluded that the SBA and the Office of Management and Budget (OMB) had overestimated the credit subsidy cost of the 7(a) program by $958 million since Fiscal Year 1992. GAO further concluded that the overestimate of defaults was the prime reason for the inaccurate credit subsidy rates.

A large portion of the $958 million overcharge is made up of fees paid to the SBA by the small business borrowers and the lenders who deliver the SBA 7(a) guaranteed loan program. As you know, under the Federal Credit Reform Act of 1990, excess fees paid as part of the credit subsidy cost of Federal loan program are sent to the general fund of the Treasury rather than being returned to the program or to the persons who made the payments.

As was discussed before yesterday's hearing at the Budget Committee, Dr. Lloyd Blanchard represented the OMB at this Roundtable. Indeed, we are very appreciative of his participation in this session which lasted over two hours. For your review and future reference, a list of the Roundtable participants is enclosed.

It is imperative that this matter be resolved before October 1, 2001, the beginning of FY 2002. Consistent with this deadline, Dr. Blanchard agreed to undertake a complete review of the information provided at the Roundtable and to work with the staffs from the GAO, the SBA, the Committee, and representatives from the lending industry in arriving at a possible and expedited solution and to report back to Committee in not more than three weeks. The Committee expects that OMB will also report on what adjustments can be made to the credit subsidy rate to make it more accurate for FY 2002.

The Honorable Mitchell E. Daniels, Jr.
Page 2

Your assistance in insuring a prompt solution to this important matter will be greatly appreciated. Small business borrowers and the lenders who deliver the 7(a) program should not enter the next fiscal year knowing that the fees they are paying are well in excess of the needs of the program. As the GAO report emphasized, this situation has persisted since 1992, and we on the Committee urge you to initiate action that is fair and equitable to our Nation's small businesses. It is vital to ensure adequate funding for small businesses to help them lead us out of the current economic doldrums.

Sincerely,

Christopher S. Bond
Ranking Member

John F. Kerry
Chairman

Testimony before the House Small Business Committee
Phil Black, Director of Community Economic Development
The Economic Development Group of People, Incorporated of Southwest Virginia

Wednesday, February 13, 2002

Thank you, Mr. Chairman and members of the Committee, for the opportunity to testify before you today. My name is Phil Black. I am the Director of Community Economic Development for People, Incorporated of Southwest Virginia and a member of the Associate for Enterprise Opportunity (AEO), the nation's association of microenterprise development organizations. My testimony represents the views of AEO as well as People, Incorporated.

I have over 16 years experience working in economic development. As Director of Community Economic Development for People, Incorporated I manage a 14-member group that operates programs in small business development, asset development, job creation, access to markets, lending and entrepreneurship training. Previous to joining the senior management staff at People, Incorporated, I worked for the North Carolina Rural Economic Development Center, a microenterprise program receiving support and recognition from the Ford Foundation, the Mott Foundation, the State of North Carolina, the US Small Business Administration and the President of the United States.

BusinesStart, the Microenterprise Development Program of the Economic Development Group at People, Incorporated has approved and closed 149 loans since its inception in January 1994. The total amount loaned by BusinesStart is $2,138,913.58 (two million, one hundred thirty eight thousand, nine hundred thirteen and fifty eight cents) with an average loan amount of $14,375. During that time, BusinessStart has also provided training and technical assistance to 1422 entrepreneurs.

AEO, founded in 1991, is the national association of organizations committed to microenterprise development. AEO provides over 400 organizational members with a forum, information and a voice to promote enterprise opportunity for people and communities with limited access to economic resources. AEO has four policy priorities for this Fiscal Year. AEO would like to see the SBA Microloan program funded at $35 million for both lending capital and technical assistance, PRIME funded at $15 million, the Office of Women's Business Ownership's Women's Business Centers Program funded at $14.5 million, and the CDFI Fund funded at $125 million. I will expand on these requests later in my testimony.

Microenterprises are small business with five or fewer employees that have difficulty accessing small amounts of credit from conventional sources. Many microentrepreneurs, particularly those served by microenterprise development organizations, are low income, women, minorities, or disabled individuals who may face other challenges to business success as well. Microenterprise is an effective economic development and self-sufficiency strategy that reduces reliance on public assistance, creates jobs, and raises income, education levels, job skills and assets of poor and moderate-income entrepreneurs. The Aspen Institute estimates that there are at least 2-million low-income microentrepreneurs in the United States.

Locally based microenterprise development programs provide credit, training, and technical assistance to microentrepreneurs. Over the past decade, several Federal programs have emerged to provide funding support to microenterprise development programs.

Conventional sources of business credit, such as bank financing, are often beyond the reach of microentrepreneurs. These potential borrowers often seek very small amounts of capital, have poor credit histories and can offer banks little or no collateral. The SBA Microloan Program continues to solve this problem by funding more than 160 community-based intermediaries to help microentrepreneurs gain access to credit. To date, Microloan Intermediaries have made nearly $145 million in loans - averaging less than $20,000 per loan. Last year, the Microloan Program received $25.5 million in loan capital – more than $3 million less than the prior year, when there was insufficient loan capital for Intermediaries needs.

As with most entrepreneurs, many Microloan borrowers require specialized technical assistance to grow their businesses. The Microloan program meets this need by providing technical assistance grants to Microloan Intermediaries and Technical Assistance Partners to allow them to provide limited assistance to borrowers in becoming credit-ready and to provide more extensive business technical assistance once they have received Microloans. Technical assistance resources are the key reason that the Program has experienced a low loss rate despite the many high-risk loans that it is able to make.

The $17.5 million that Microloan received in Fiscal Year 2002 represented a $2.5 million cut in funding, or 12.5%. That however, has not been the true impact on the provision of services. Technical assistance grants are calculated as a percentage of outstanding loans for Intermediaries. Because the program has thrived, growing from $80 million in outstanding loans to $110 million, technical assistance was actually cut by 40%, rather than the overall 12.5%, for all Intermediaries. Technical assistance has been severely curtailed and several organizations will be forced to lay off staff.

In order to succeed in our complex economy, microentrepreneurs need training and technical assistance is areas such as financial management, book-keeping and marketing. In fact, a 1999 study by the Aspen Institute found that nearly 90% of microentrepreneurs do not seek microloans, but instead seek training, technical assistance and access to markets services. As indicated in BusinessStart's program statistics, this holds true for our program as well. The Program for Investment in Microentrepreneurs (PRIME) provides grants to microenterprise development organizations to offer training and technical assistance to entrepreneurs, regardless of whether they seek access to capital. Governing legislation stipulates that 50% of the PRIME Act's funds be used to support training and technical assistance for low-income entrepreneurs. A five year study by the Aspen Institute, the Self-Employment Learning Project, found that entrepreneurs receiving these services had highly favorable outcomes in household income and assets, business income and assets and reduced reliance on federal benefits.

The PRIME program is authorized to receive $15 million per year. Last year's $5 million funding level represented a 66% cut in the program and resulted in at least a $15 million decrease in training and technical assistance services that start-up businesses desperately need in a time of recession.

The SBA's Office of Women's Business Ownership (OWBO) is the only federal office that specifically targets women business owners. Its Women's Business Centers provide training and technical assistance to women starting or expanding businesses. There are a total of 92 Women's Business Centers. Fifteen new Centers were added this year. The Centers are required to target services to economically and socially disadvantaged women, some of whom are microentrepreneurs. The Centers create opportunities for networking among women business owners and are particularly responsive to their needs. Over the past ten years, Women's Business Centers have provided consulting, training and technical assistance to more than 50,000 women.

The Community Development Financial Institutions (CDFI) Fund, administered by the Department of Treasury, makes capital grants, equity investments and capacity building grants to community development financial institutions. CDFIs are specialized financial institutions that work in market niches otherwise underserved by traditional financial institutions. They are credit unions, community development banks, loan funds, venture capital funds, and microenterprise loan funds. The Fund also provides incentives for bank and thrift investments in distressed communities. The CDFI Fund has been instrumental in building equity and capacity for the microenterprise industry to provide loans and other forms of financing.

In conclusion, Mr. Chairman and members, I would like to put a human face on the statistics, facts and numbers I have shared with you today.

1. **T & S Trucking, Inc.**

Business Location:	Smyth County, Virginia
Start-up date:	Summer 2000
Loan amount/term:	$19,000 / 4 years

   Quote from borrower for 2001 Annual Report:
   "My husband, Terry, and I became familiar with BusinesStart when we wanted to start our own trucking company. We drove a straight truck for two years for the Fed-Ex Corporation as leased drivers. We learned that we could make more money and have more control over our driving time if we could become owner-operators. We met several times with Ron Topshee, the business development specialist, and he was instrumental in helping us get the loan money we needed to start our own trucking company. We are now the owner-operators of T&S Trucking, Inc., with our truck leased to Fed-Ex in their Custom Critical Division. If you are really tired of getting laid off, I would suggest you consider starting your own business. Working for yourself is hard work, but it is also a dream come true. And the best part is that you don't have to go far to find the information you need to start. They're in your own backyard." -- Carolyn Hutton

2. **Family Pet Supply**

Business Location:	Buchanan County, Virginia
Start-up date:	Fall 1999
Loan amount/term:	$5,000 / 3 years, $4,000 / 3years

   Quote from Owner, Sandra Blankenship
   "The small business start program is described on paper as a place to get money but that's not exactly accurate. You get something more valuable than money. At People, Incorporated I found knowledge, encouragement, support, and understanding from a friendly caring group of people. When I recommend someone go to People, Incorporated before going to a regular bank, I am recommending they seek knowledge and a good understanding of what being self employed really means. I am on my second loan from the small business start program. With the second loan I am purchasing equipment to take my business into a more profitable direction and I'm taking Debby (Business Development Specialist) with me. Her advice and business knowledge are invaluable to me. I am grateful for all I have received from People, Incorporated. They are more about life than money."

Thank you very much for this opportunity. I would be happy to answer any questions at the appropriate time.

NASBIC
America's Small Business Partners

Statement
of
Lee W. Mercer
President

National Association of
Small Business Investment Companies

Before The

United States House of Representatives
Committee on Small Business

February 13, 2002

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Chairman Manzullo, Representative Velázquez, members of the Committee:

On behalf of the National Association of Small Business Investment Companies, I appreciate the opportunity to testify today concerning the Administration's FY 2003 SBIC program budget proposal. I am pleased to report that the budget has the unqualified support of the SBIC industry. We urge the Committee to support the SBIC budget proposal as submited.

The budget calls for the availability of $4 billion in Participating Security leverage and $3 billion in Debenture leverage. As is the case this year, FY 2003 leverage would be supported 100% by fees and interest paid to the government by Debenture SBICs and by fees, prioritized payments, and profit distributions paid to the government by Participating Security SBICs. The per annum portion of those costs will be virtually unchanged from the FY 2002 rates. Thus, as is the case this year, no appropriation will be required to make $7 billion available. When added to the minimum required private capital, $10 billion in new capital will be made available for SBIC investments in U.S. small businesses.

At a time when the U.S. economy can use all the financial help it can get, SBICs are proving their value as steady and reliable sources of venture capital for America's small business entrepreneurs. For the fiscal year ended September 30, 2001, SBICs invested $4.6 billion in 2,254 companies. Although the total invested was down 18% from the record $5.5 billion of FY 2000, it was 7% more than the $4.2 billion invested in FY 1999, with 14% more companies receiving financing than in FY'99. Of great importance to small businesses seeking capital, SBICs are proving to be a far more stable source of financing than non-SBIC venture capital funds. According to Venture Economics and the National Venture Capital Association, for the same fiscal 2001 period, all venture capital investments totaled $52.3 billion, down 51% from $106.1 billion the total invested in the same fiscal 2000 period. Calendar-year statistics are even more revealing. All venture capital investments dropped from $99.6 billion in 2000 to $36.6 billion in 2001—a 63% drop. SBIC investments dropped just 3% for the same period.

SBICs continued to be a significant source of capital for new businesses, with 58% of all FY 2001 investments made in companies in business for three years or less. The average size of investments by all SBICs continued at the $1 million mark while non-SBIC investments averaged $11 million for the same period. For leveraged SBICs, the average and median investment sizes were well below the $1 million level. These numbers speak to the importance of SBIC capital to the great numbers of younger, smaller, less capital-intensive companies that become important parts of the economic foundations of their respective communities. In this regard, it is interesting to note that almost $1 billion, 22% of total investments, were made in companies located in Low- and Moderate-Income areas as defined by the government. I have attached a sheet containing some of the relevant FY 2001 SBIC investment statistics to further underscore that SBICs are producing the results that Congress intended when its redesign of the program became effective in FY 1994. We are pleased to note that the Administration has also recognized the effectiveness of the SBIC program in its rating of SBA programs for budget allocation purposes.

Total SBIC capital resources rose from $15.4 billion at year-end FY 2000 to $18.8 billion at the close of FY'01—an increase of 22%. Further, despite the fact that raising venture capital is substantially more difficult at present, the SBIC program continues to grow. Private investors committed $1.1 billion in new private capital to the 51 new SBICs licensed in FY 2001, down 9% from FY 2000, but 47% more than the $747 million committed in FY 1999. The backlog of current license applications at SBA and the rate at which new applications are being received make it likely that a similar number of new funds will be licensed this year. This will ensure the continued flow of critical venture capital to the fast growing U.S. small businesses that are the foundation of U.S. job creation and economic growth.

With the jarring economic contraction we have experienced over the past 18 months or so, some losses in the SBIC program are to be expected. Economic business cycles apply to SBICs just as they do to all other business endeavors. However, the SBIC program remains strong. The SBIC program is designed to stimulate the flow of scarce venture capital to U.S. small businesses in such a way that over time the government neither makes money nor loses money in connection with the augmentation of private capital by government-guaranteed capital. Using a complex model, the Office of Management and Budget (OMB) sets the "reserves" that must be established each year to meet potential out-year losses associated with the projected failure by some SBICs to repay some or all of their leverage. While there is no "lock box" for the annual reserve amounts, they are made up of fees, interest, prioritized returns, and profit shares paid directly to the government by SBICs and, when required, annual appropriations agreed to by Congress. The balance of these "reserves" for the period FY'94–FY'01 was approximately $500 million at the close of FY'01. Since the private capital of each fund is at risk before government-guaranteed capital, the practical reserves are even greater, and more funds are being added to reserves in FY'02. The program is in a strong position to weather the current economic cycle over time and will all the while continue to be a constant source of venture capital for starting and expanding U.S. small businesses.

Suggested Legislation To Increase Private Capital Investment In Debenture SBICs

As we did last year, we ask your support for legislation that would exempt income received by tax-exempt institutional investors from Debenture SBICs they might invest in from treatment as Unrelated Business Taxable Income (UBTI) under the Internal Revenue Code (IRC). These investors include pension funds, charitable foundations, and university endowment funds. UBTI is subject to filing requirements and taxation and creates a strong, almost total, disincentive for tax-exempt investors that might otherwise be interested in investing in one or more Debenture funds. The exemption would provide Debenture SBICs with access to substantial sources of potential private capital that are not available to them at present, capital sources that are available to Participating Security SBICs and other equity based venture capital funds.

UBTI is created automatically by Debenture SBICs because the government-guaranteed capital used to augment private capital in the Debenture program is borrowed capital. It is structured that way by the provisions of the Small Business Investment Act. The IRC treats the borrowed capital as "acquisition indebtedness," indebtedness that triggers UBTI. This is unlike the Participating Security program wherein the government-guaranteed capital is structured as an equity investment by the government in the SBICs receiving the same.

UBTI treatment makes it virtually impossible for Debenture SBICs to raise private capital from tax-exempt institutional investors. The reason is not that tax-exempt institutional investors do not invest in venture capital funds. They do. According to Thomson Financial / Venture Economics of Newark, New Jersey, institutional investors provide as much as 60% of the capital invested in venture capital funds each year. However, given the option of investing in venture capital funds that create UBTI and those that do not, it is not surprising to learn that tax-exempt investors almost always opt to invest in the latter category of funds. Investments in equity-based funds do not create UBTI for tax-exempt investors.

UBTI tax rules that serve as roadblocks for Debenture SBIC managers trying to provide the above loans have no place in the context of the SBIC program. The express congressional policy of the Small Business Investment Act is: "to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loans which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization ... provided, however, that this policy shall be carried out in such a manner as to insure the maximum participation of private financing sources." Section 102 of the Act, emphasis added. Private capital held by tax-exempt organizations represents the large majority of private capital potentially available to SBICs for investing in domestic small businesses. To advance the express policy of the Small Business Investment Act, it is reasonable that Congress exclude from the definition of UBTI any income received by a tax-exempt organization that is derived from an investment in an SBIC.

The Debenture SBIC program was designed to enable Debenture SBICs to make loans to small businesses that are generally subordinate to, and may be the basis for, more senior credit facilities from commercial banks. As such, these subordinated loans are often critical to the survival of the small businesses that secure them. Such loans are particularly suited for family-owned businesses that may never reach the growth required to "go public," or, for companies whose owners may never want to give up equity in (or control of) their companies by the sale of large blocks of stock. These companies are often found in the heartland of America, not the "hot" locations that typically attract media attention. Nonetheless, these companies are important to America's economic wellbeing in general and the health of their local communities in particular. They are often primary employers in the areas in which they are located.

There will be little or no tax revenue loss if an exemption from UBTI consequences is provided for tax-exempt institutional investors investing in Debenture SBICs. At year-end FY 2001, we estimate that less than $35 million in tax-exempt investor funds were invested in Debenture SBICs—only 2% of the $1.6 billion in private capital invested in all Debenture funds. We estimate the revenue impact will be no more than $1 million per year. We have strong support in the Senate for the proposed change. We hope that, following your consideration of the issues involved, the Committee will support the proposed change as well and work with the Ways and Means Committee to see it included in an appropriate piece of legislation. Adopting the change is the single most effective step Congress could take this year to increase private capital investment in Debenture SBICs and, therefore, in the small businesses they serve.

Thank you again for your consideration our views. We look forward to working with you again this year to further improve the SBIC program and its ability to help meet the venture capital requirements of America's small businesses.

NASBIC
America's Small Business Partners

Small Business Investment Company Program Statistics

Fiscal Year 2001 SBIC Data From SBA Reports

Investments By Type Of SBIC	Number	Total $ Amount	$ %	$ Average	$ Median
Participating Security SBICs	1,879	1,443,486,832	32%	768,221	300,000
Debenture SBICs	1,256	694,087,131	16%	552,617	163,161
Bank SBICs (No Leverage)	832	2,272,926,251	51%	2,731,883	1,064,275
Specialized SBICs	310	44,774,829	1%	144,435	50,000
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Category Of Investments					
Straight Debt	1,066	289,633,931	7%	271,702	78,133
Debt With Equity Features	1,349	903,422,529	20%	669,698	225,000
Equity Only	1862	3,262,218,583	73%	1,751,997	796,127
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments By Business Age					
Under 3 Years	2,285	2,568,339,023	58%	1,124,000	250,000
3 to 6 Years	924	969,993,147	22%	1,049,776	334,056
6 to 10 Years	436	285,358,160	6%	654,491	249,498
Over 10 Years	632	631,584,713	14%	999,343	267,337
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments By Business Type					
High Technology Businesses	1,664	1,916,853,818	43%	1,151,955	400,500
All Other Businesses	2,613	2,538,421,225	57%	971,459	210,000
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments In LMI Areas					
Low-Income Areas	633	562,146,200	13%	888,067	160,000
Moderate-Income Areas	487	425,416,973	10%	873,546	200,000
Total LMI Investments	**1,120**	**987,563,173**	**23%**	**881,753**	**186,463**

Notes:

1. A total of 2,254 small businesses received SBIC financing from 4,277 investments made in FY 2001.
2. The median number of employees in SBIC-financed companies in FY 2001 was 30.
3. The average non-SBIC venture capital investment equaled approximately $11 million in 2001.
4. Approximately 85% of all non-SBIC venture capital investments are made in high-technology firms.
5. Participating Security SBICs had distributed $279 million in profits to SBA through February 6, 2002.
6. SBIC investments were 55% of transactions and 12% of total dollars for January-September 2001.

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National Association of Development Companies
NADCO

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program
Proposed FY 2003 SBA Budget

Submitted to the

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

by

Mr. Christopher L. Crawford

Executive Director

National Association of Development Companies
McLean, Virginia

February 13, 2002

The National Association of Development Companies (NADCO) is pleased to provide a statement to the House of Representatives Committee on Small Business concerning the SBA budget proposed by the Administration for FY 2003. NADCO is the trade association for SBA 504 Certified Development Companies (CDCs). We represent 250 CDCs and more than 175 affiliate members, who together provided more than 98% of all SBA 504 financing to small businesses during 2000. NADCO's mission is to serve as the key advocate for the 504 program, and to provide program technical support and professional education to our membership. As the Committee knows, 504's objective is economic development and specifically job creation by funding the expansion of small businesses. No other Federal program can claim to have created almost 1,000,000 jobs, as the 504 program has done. This mission is more important today than ever before, with our economy stuck in neutral at best, and in recession at worst.

NADCO would like to thank Chairman Manzullo, Ranking Member Velazquez, and the entire Committee, for continued support of the 504 program and the CDC industry. Your Committee has worked closely with the Congressional leadership, SBA, and our industry to ensure the availability of capital to small businesses through the 504 program previous to and during this recession. We would especially like to thank Chairman Manzullo for inserting important Report language in the FY 2001 Treasury – Postal Appropriations bill concerning the 504 subsidy model. This language requires the Administration to provide a report to the Committee on progress to correct the subsidy model. We await this report from OMB.

We have three objectives in providing this testimony to the Committee. First, NADCO would like to comment on the FY 2003 SBA budget. This includes the Administration's 504 authorization level, as well as the proposed borrower fees and subsidy model assumptions by SBA.

Second, we will comment on several of the management initiatives raised in the Administration's budget. Third, we will address the need for continuing vigilance by this Committee over the fees imposed by the Administration on our borrowers, first mortgage lenders, and CDCs for use of the 504 program.

PROPOSED SBA FY 2003 BUDGET

First, I must express our industry's disappointment with both the timing and completeness of information provided to us in anticipation of this important hearing. Although the President's budget was released on February 4th, the Administration did not provide any details on the 504 subsidy model assumptions, authorization, or other budget items until a meeting on Monday. This lack of communication has left us no time to thoroughly review these forecasts, or request any additional information on SBA budget assumptions. I must assume this situation is due to SBA's expectations that we may disagree with many subsidy model assumptions.

1. 504 PROGRAM AUTHORIZATION LEVEL

SBA has proposed that the authorization level for the 504 program be set for FY 2003 at $4.5 billion. We support this level of authorization for 504. As the program continues to fund itself through borrower, CDC, and first mortgage lender fees, there is no cost to the Federal government, nor any Congressional appropriation.

The benefits to the country are numerous. New 504 projects provide new jobs in their communities by expanding the land, equipment, buildings, and employment levels for our borrowers. In turn, this expansion leads directly to new tax bases, including:

- **City & County real estate taxes from new construction projects**
- **State & local sales taxes from increased business revenues**
- **Federal & State income taxes from new and expanding businesses**
- **Federal & State payroll taxes from new employees.**

It is clear that businesses assisted by this no-cost program are contributing to the tax revenues received by all levels of local, State, and Federal governments. We encourage this Committee to support this authorization level during this economic recession when every job we create is putting someone back to work.

2. 504 BORROWER FEE INCREASE

SBA's proposed FY 2003 budget increases the annual fee charged each 504 small business borrower from 0.410% to 0.425%. We are shocked and dismayed at this increase, in light of our understanding of the portfolio's performance and the success of key new initiatives.

While a relatively small increase in user cost, this change appears to herald a new and totally unjustified concern by the Administration about the performance of our 504 loan portfolio. We find this surprising. The most important subsidy model factor is loan defaults. In the SBA model, defaults actually are forecasted to decline.

As noted above, this is not a true "subsidy" model, but actually a cost model. There is no Congressional appropriation that provides a 504 subsidy. The fees paid by borrowers, our CDCs, and even our first mortgage lenders offset completely the program operating expenses. Thus, this is a free program for the taxpayer. Further, it is, in fact a cash cow, given that it is providing excess fees back to the Treasury. SBA's own re-estimates for this year demonstrate that 504 will have returned almost $400 million in excess borrower fees during the last five years. We question how the agency can in good conscience decide to increase the borrower fees when borrowers are actually providing hundreds of millions of dollars to the Federal government.

Several factors influence the program cost model, which leads directly to the borrower fee. I will address each separately, based on my knowledge of our program's true historical portfolio performance, rather than subjective assumptions.

Loan Default Rate:

The 504 loan default rate improves from 8.4% down to 8.3%. While we welcome this improvement, it brings up two more issues. (A) How can you see a decline in portfolio currency, yet see an improvement in defaults? My experience is that, when currency declines, defaults go up rather than improve. (B) Based on a brief study by SBA and OMB last year, there appears to be very old loan data that is driving down SBA forecasts of performance. When this Committee requested the Administration to analyze a change in the "look back" period to ten years, our default rate was actually cut in half – to about 4%. Why was this cost model change not implemented, since it uses the most recent and accurate loan data reflective of our current program operations?

Attached to this testimony is a chart provided by Bank of New York, the 504 program Trustee bank. This chart reveals to significant items. First, prepayments have spiked. More on this below. Second, loan defaults have actually remained fairly constant for the last ten years. During this time, our annual loan volume has grown from about $300 million to almost $2.5 billion. This means that the actual default percent has fallen rapidly and remains well below SBA forecasts.

Further supporting our concern about the accuracy of this forecast is the President's own budget figures. On page 49 of the SBA Budget Request and Performance Plan is the following statement: ***"Defaults amount to about $60 – 70M annually".*** This clearly agrees with our chart that 504 loan defaults have been very consistent for many years. At a rate of only $2.5 billion in annual loans, this amounts to <u>less than a 3% default rate</u>. We ask the Committee to request reconciliation of this 3% figure with the budget's factor of 8.3%.

<u>504 Loan Currency Rate:</u>

SBA forecasts that 504's loan portfolio currency rate will decline from 98.5% to 95.5%. Given that last year saw the peak of this recession, we should expect the 2003 loans to improve, rather than decline in their currency rate. With virtually all 504 loans being for real estate, we cannot identify any reason why loans with such collateral would suffer any decline in their currency rate while working capital loans maintain a constant level of currency. Our experience with business real estate loans is that these are the absolute last debt a business owner fails to pay. The owner knows that a default on his business property essentially drives his business to a complete failure when he is thrown out of his property by lenders. Most business owners pay their business property loans even before their home mortgages. We seek further clarification from SBA on this unusual forecast.

<u>Loan Recovery Rate:</u>

Third, SBA's forecast of their recoveries on defaulted loan collateral again declines – to an abysmal 20% from last year's 26.9%. We cannot understand this forecast, given the clear results of two on-going SBA programs. One program, the Congressionally-mandated 504 liquidation program, has had very positive results. With virtually all loans accounted for, the average recovery rate for both CDC and SBA staffed efforts has easily exceeded 50% of the outstanding 504 loan balance.

The other program, the SBA asset sale program, has resulted in a sale of 872 504 loans for over $170 million. Again, the recovery rate has been over 50%. Even the Administration's own budget proposal notes that **"the Agency implemented a highly successful asset sale program and will continue to strategically sell our loan portfolio."** Frankly, if a 20% net recovery is the definition of highly successful, SBA should seriously consider allowing more private lenders and CDCs to perform the recovery process. 20% recovery just doesn't cut it.

The budget shows that the major reasons for continued decline in the net recovery rate is high collection expenses. Each of the above initiatives – the CDC liquidation program and the asset sale program – should see very few SBA expenses. CDCs doing the 504 default recoveries are shouldering their collection costs. The asset sales should reduce liquidation and recovery costs for SBA, given that few staff are involved in sales and no servicing is needed for the loans being sold. Yet, it appears from budget assumptions that SBA's forecast of collection expenses remains extraordinarily high – almost 40% of the loan balances. It seems that either SBA's costs are out of control, or their new accounting system has not figured out which costs to allocate to the asset sales. Given the apparent successes of these two programs, we cannot understand how the overall recovery rate would continue its decline. We believe the Committee should seek detailed and independently verifiable information on the asset sales and the SBA loan recovery expenditures.

During our Monday meeting with SBA, we learned that SBA collection forecasts do not include proceeds from secondary notes by loan guarantors, or notes from sales of foreclosed 504 assets. SBA did not provide any data on the number or total value of these notes that they now own. However, we believe that many 504 defaults result in either a sale of the real estate, with SBA taking back a note, or perhaps one of the original borrowers providing a new note to SBA based on his personal guaranty of the original 504 note. It would appear that the program subsidy model in counting as a total loss the payoff by SBA of the 504 debenture, but giving the program no credit for many recoveries that involve notes. This is clearly lowering the recovery rate and increasing the borrower fees for no reason. We ask the Committee to investigate this procedure, and correct it as quickly as possible. This should be done even for the FY 2003 budget model.

Loan Prepayment Rate:

SBA's forecast of the loan prepayment rate continues to be about 50% of our loans. This appears far too high, based on actual history of our portfolio. Obviously, when prevailing private rates are low (as now) there will be some prepayments of 504 loans. However, while these rates have "blipped up" in the last six months (as the chart shows), they are already rapidly moderating. However, these loans prepaying are not even in the current 2003 loan cohort, and thus cannot be considered part of this year's forecasted prepayment rate.

Additionally, the 504 debentures to fund our loans this year are being sold at historic low interest rates. Recent sales have been at rates below 6%. With no expected increase in long term rates for the next several months, we cannot imagine the small business who will find lower rates from the private markets, and decide to refinance in the next twenty years. Even with commercial banks providing low rates, the 504 loan volume is reaching record new highs. Thus, we strongly disagree with SBA's assumption of a high prepayment rate for FY 2003. We ask the Committee to obtain detailed information about this forecast, and compare it with recent historical trends of our actual portfolio prepayments as recorded by our Trustee bank.

SBA MANAGEMENT INITIATIVES

Strategy #2: Manage Human Capital More Strategically

We strongly support the need for this management strategy. With loan volume growth continuing even as SBA staff shrinks, SBA must "work smarter, not harder." There will simply not be enough field staff to perform all the loan underwriting, authorization, closing, servicing, and liquidation functions required of a $50 billion loan portfolio. The agency's existing PLP and PCLP programs point the way to the future; off-load work better done by others, and allowing SBA staff to perform quality lender oversight. You don't see the OCC performing individual loan underwriting and servicing actions, but everyone certainly thinks the banking industry is well regulated through OCC's audit and control functions. Perhaps SBA should emulate the OCC. Additionally, SBA's plan to expand centralization of many repetitive actions that require unique expertise is a very positive move. This has proven to be successful in the two loan servicing centers now in operation. These specialized staffs are able to increase productivity and reduce costs, while actually providing improved service to lenders and borrowers.

There is also increased focus on staff training. We endorse this objective, and hope it goes beyond only generic management training. With retirements by many senior field office staff, there appears to be declining expertise in the core lending and servicing skills needed to oversee SBA's programs. For a number of years, SBA staff participated in lending industry training, including NADCO's, to learn the same skills we teach our own industry members. We are encouraged that SBA may again focus on staff training, and suggest that the agency work with lender industry groups who provide cost-effective program training to their members. This method may be less costly than creating their own training programs on basic finance, credit, and lending.

Strategy #3: Improve Financial Management Information
Strategy #6: Improve Credit Program Management

We strongly support the need for these objectives. The Loan Monitoring System actually began nearly five years ago as a joint review of the 504 program operations by SBA and CDC staffs. As I have observed this system development over the years, it has stopped and started several times – each time with different contractors who knew little or nothing about SBA lending programs, yet were expected to design systems to automate highly sophisticated lending and servicing procedures. This project appears to have made little or no progress, while burning through millions of taxpayer dollars. It should be "reconstituted" as stated by the Administrator, and should take advantage of the knowledge and skills of the lender industries that it will provide information both to and about. At this time, it does not appear that the agency has either the data processing or loan portfolio management skills to plan, design, or develop this system in-house.

We support the implementation of the Congressionally mandated liquidation authority for qualified CDCs. Long-standing Members of this Committee may recall that the liquidation pilot was actually our industry's idea to improve loan recoveries. Further, our member CDCs agreed to absorb the costs of liquidation and workout efforts due to agency budget shortfalls. The recently completed liquidation pilot dispelled the notion that numerous experienced CDCs might not be able to perform adequate loan recoveries. This pilot has been a sterling success through the joint efforts of talented SBA staff and many CDCs. Further, given the apparent belief by SBA that their own recovery efforts may yield only a paltry 20%, it might be best for everyone if privatization of 504 loan recovery efforts was accelerated, rather than rely on the loan asset sales.

Increased Use of 504 For Larger Real Estate Loans

In order to stretch the appropriation for the 7(a) loan program, SBA indicates it may consider a forced shift of some real estate loans now done under 7(a) to the 504 program. We support efforts to increase awareness and use of the 504 program. We are also committed to ensuring that the program is being delivered throughout the U. S. through local CDCs. While SBA's proposal might appear to be a quick fix, there are a number of reasons why this may not work to the benefit of SBA's small business borrowers. Many projects financed under 7(a) simply won't qualify under current law or regulations for 504 loans. Among the reasons are:

- 504 cannot be used to refinance an existing permanent loan.
- 504 cannot normally be used for projects less than $100,000.
- 504 cannot be used if the borrower needs a term of less than ten years, or if a variable interest rate is best for the borrower.
- 504 cannot easily be used for a "mixed use" project, where the borrower also needs financing for working capital, inventory, receivables, or fixtures.
- Most importantly, 504 loans are for economic development, and have a strict job creation and retention requirement. Many 7(a) projects do not meet this standard.

Surmounting these restrictions would clearly require new legislation to modify Congressional intent for 504. Further, major regulatory and SOP revisions would be required of the agency. These would likely consume much of this and the next session of Congress, and much of the Administration's management time. It would also require substantial discussions with the lender industries to achieve any consensus on legislation or regulations. It does not appear that this proposal could be a short term fix for any 7(a) budget shortfall.

504 SUBSIDY: THE NEED FOR VIGILANCE

Through this statement, we have noted that we have closely monitored SBA and OMB 504 program cost and fee calculations for some years. The borrowers who use this program and the CDCs and first mortgage lenders who pay additional fees to support the program deserve to understand how the fees are calculated that they are being required by a Federal agency to pay to the Federal Treasury.

In doing the program re-estimates last year, it was clear that 504 had gone the same way as the 7(a) program: we are now in "negative subsidy". That is, we were paying more into the Federal Treasury in borrower and user fees than the program actually is projected to cost. We believe this to be nothing less than an unauthorized tax on America's small businesses. Data from SBA's budget reveals the following re-estimates by year:

- FY 1999: $13.032 million paid in excess fees to Treasury
- FY 2000: $9.676 million "
- FY 2001: $105.186 million "
- FY 2002: $180.143 million "
- FY 2003: $88.672 million "
- Total 5 years: <u>$396.709 million</u> paid in excess fees to Treasury

When SBA and OMB overestimate the true cost of our program, this is no longer a bureaucratic funny-money budget exercise. The result is real fees paid by real borrowers in real money to the U. S. Treasury. Six year ago, SBA "guesstimated" that the 504 default rate was 19%. There was absolutely no historical data to support this figure. With no appropriation, this led to our small business borrowers having to pay new and incredibly expensive program fees. Those borrowers from 1997 will be paying these fees in every loan payment every year for the entire twenty years of their 504 loans. While SBA can "re-estimate" its projections to correct future program forecasts, our existing borrowers will still pay the inflated fees from the old SBA program cost models. There is no correction provided to loans already in the portfolio.

The SBA-OMB 504 subsidy model results have been very inconsistent with our analysis of historical portfolio performance. Last year, OMB and SBA provided this Committee with projections of 504 defaults under a plan to reduce the reliance on very old and generally incomplete loan data. That is, SBA was considering shortening the "look back" period for our subsidy model. When finally given access to the results of their forecasts, we were quite surprised to find that they were very close to historical actual figures. We are puzzled about SBA and OMB's unwillingness to move to utilization of model interpretation that so clearly correlates with true history.

For example, the SBA-projected default rate for 504 dropped from about 11% to under 5% just by going to a shorter look-back period. This appeared to be very close to the 4% that the program has achieved since its creation in 1986. We recognize that many of our loans are still "young" and future defaults can be expected. However, even SBA's own analysis has shown that the vast majority of defaults occur in the first four or five years of a loan pool. However, instead of correcting its model to better reflect the program's history, SBA is now considering a move to a totally new model: the Econometric Model, which has been discussed for several years.

Our industry is concerned that changing the model may provide no more accurate subsidy and borrower fee forecast than the old model. In fact, we have never argued over the model structure, which is just a bunch of mathematical formulas set up in a giant financial spreadsheet. Our concerns center on how SBA and OMB look at our portfolio performance historical data, and come up with the forecasts they do. Thus, we believe they have a data interpretation issue, not a financial model structure issue.

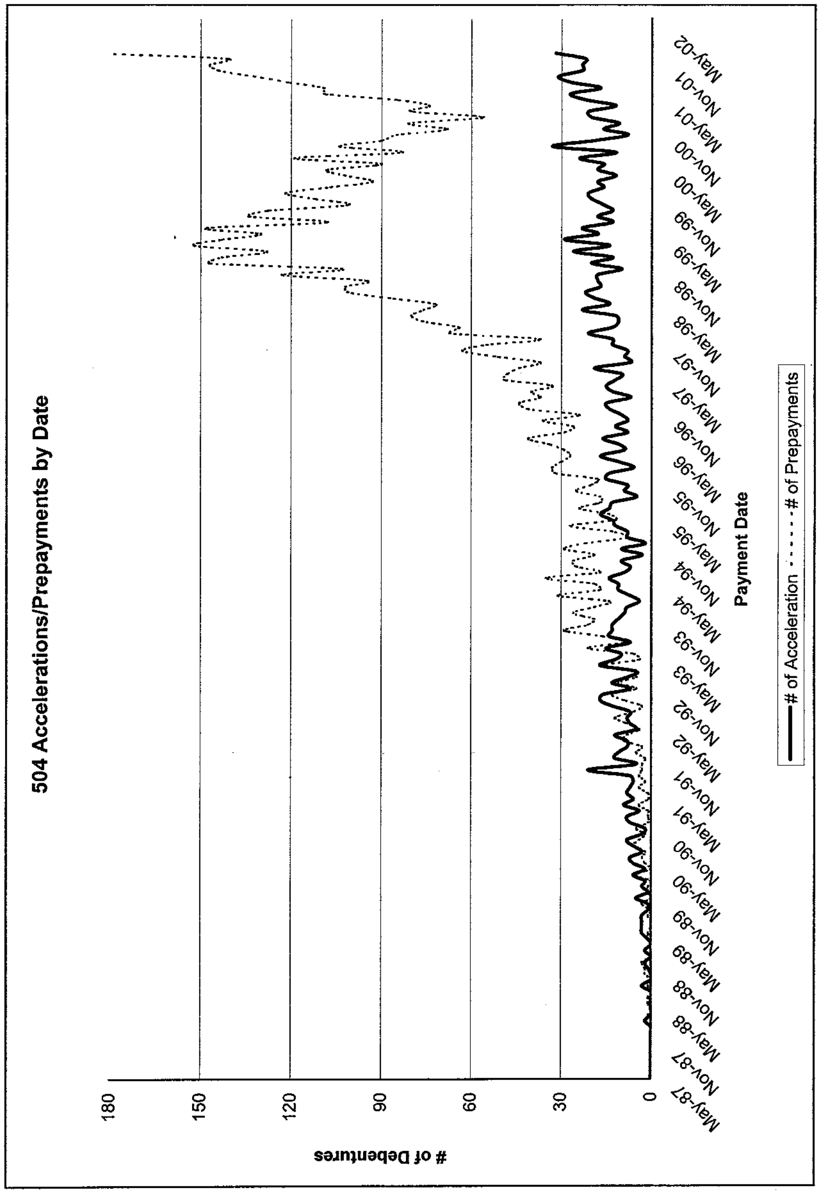
We do not understand how changing the model is going to improve their track record of poor default and recovery forecasting, as demonstrated by the huge "negative subsidy" generated over the past five years. What this action will do is "re-set the game clock"; that is, they will now have five more years to demonstrate that they may eventually get a model that might provide accurate forecasts of our portfolio performance. Until they get it right, or until this Committee is finally fed up with these moving targets and misinformation, our 504 borrowers will continue to pay what we believe to be grossly inflated user fees. Assuming our program remains in "negative subsidy", these fees will continue to flow to the U. S. Treasury Department. As has been the case for the 7(a) program for years, these excessive fees will continue to amount to an unauthorized tax on our borrowers.

Our industry strongly objects to this situation. We ask the Committee get to the bottom of the Administration's gyrating program statistics, as Treasury- Postal Appropriations directed OMB in its Report. We ask for a true determination of whether 504 is in "negative subsidy" and simply turning over excess fees to the Treasury. If this is the case, we ask this Committee and the Congress to initiate legislative steps to halt this practice. This may require that the Congress legislate our program's fees or place caps on these fees that are based on true program historical performance.

SUMMARY

There are many issues to be addressed for the 504 program if we are to improve it. NADCO recognizes the Committee's support for changes to improve and expand the program across America. Now, we must get SBA and OMB to recognize the true value of the many Congressional and industry improvements implemented during the past several years. Such improvements have clearly enhanced the quality of our lending practices, and long term portfolio performance. Our challenge is to make the Administration recognize the value of these positive changes.

Thank you for allowing us to provide our comments. CDCs are major stakeholders in the 504 program and want to do everything we can to ensure its long term viability. Even though we are at zero subsidy with no appropriation, we consider the program cost model factors to be a very serious matter. As quickly as we are able to obtain more detailed and comprehensive information about the Administration's cost model forecasts for FY 2003, and perform our own independent analysis of their projections, NADCO will be pleased to work with the Committee to get to the bottom of the subsidy issues.


504 Accelerations/Prepayments by Date
# of Debentures
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STATEMENT OF

DONALD WILSON

ASBDC PRESIDENT and CEO

REPRESENTING THE

ASSOCIATION OF SMALL BUSINESS DEVELOPMENT CENTERS

SBA's BUDGET FOR FY 2003

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

FEBRUARY 13, 2002

Statement of

Donald Wilson

President, Association of Small Business Development Centers

February 13, 2002

Before the

U.S. House of Representatives Committee on Small Business

Chairman Manzullo, Ranking Member Velazquez, members of the House Small Business Committee, I am Donald Wilson, President of the Association of Small Business Development Centers (ASBDC). The Association represents America's Small Business Development Center Network. The nationwide network of 58 state and territorial programs has almost 1,000 service centers in all 50 states, the District of Columbia, Puerto Rico, Guam, the Virgin Islands, and American Samoa. On behalf of the nearly 6,000 dedicated men and women who work in the Network, let me thank you for inviting ASBDC to testify at this important hearing on the FY 2003 Small Business Administration Budget. In light of the nation's current economic conditions it is vitally important that Congress focus on what federal resources will be directed to assist and support the small business sector of the economy.

Mr. Chairman, America's Small Business Development Center Network is the SBA's largest management and technical assistance program. SBDCs serve more clients than all other SBA programs, credit and non-credit, combined. SBDC service centers provide businesses help in setting up their books, with developing business and marketing plans. SBDC personnel train clients in how to use computers and accounting software. SBDC counselors advise clients how to better manage personnel, and how to manage inventory. SBDC employees help clients to identify potential markets at home and abroad. And they provide these services in a highly professional manner. Studies of Pennsylvania and New York SBDC clients indicate that firms who have received SBDC counseling tend to have a greater survivability rate than the general small business population. In FY 2001 the SBDC program provided counseling and training assistance to almost 610,000 clients. These figures represent a 4.6% increase over FY 2000. For example, Mr. Chairman, in your home state of Illinois, the number of SBDC counseling cases increased from 9,737 in FY 2000 to 10,627 in FY 2001. In Ranking Member Velazquez's state of New York, counseling cases increased from 32,015 in FY 2000 to 34,420 in FY 2001. And these numbers do not reflect the hundreds of thousands of informational requests that are handled nationwide by the Network on an annual basis. In response to emails, faxes, phone calls or drop in visits, SBDC staffers provide helpful but routine information to clients seeking information on such topics as where to get a business license or how to secure an employer identification number.

These case numbers reflect the continuing demand by aspiring entrepreneurs and existing small business owners for management and technical assistance from the SBDC program. It should also be brought to the committee's attention that 43% of SBDC clients in FY 2001 were women, 24% were minorities and over 7% of the program's clients self-declared themselves to be veterans.

Mr. Chairman, America's Small Business Development Center Network will celebrate its 22nd anniversary this year. It is a small business management and technical assistance network without peer. The network has served nearly 9 million clients since its inception. In the last 6 months, ASBDC, on behalf of the Network, has signed a partnership agreement with the U.S. Forest Service to provide management assistance to vendors who provide services on Forest Service lands. ASBDC, late last fall, signed a partnership agreement with OSHA to increase small business awareness of certain OSHA regulations such as OSHA's record keeping requirements. ASBDC is working in partnership with the Energy Star program at EPA and the Rebuild America program to develop a curriculum to educate small businesses on ways to improve their bottom line through improved energy efficiency. ASBDC is also working with the International Franchise Association to develop a program that will make minorities more aware of business opportunities as franchise owners. The association is also working separately with the National Black Chamber of Commerce and the U.S. Hispanic Chamber to develop working partnerships designed to increase SBDC outreach to minority clients.

The Administration's recommendation of $88 million in funding for the SBDC program for FY 2003 is recognition of the contribution the SBDC program makes to the well being of the small business sector of our economy. Hopefully, it also reflects a growing awareness at OMB of the importance of small businesses to the economy. In 1998 the SBA office of Advocacy released a report entitled, The New American Evolution: The Role and Impact of Small Firms. That report asked the rhetorical question, "Are small firms important?" The answer the report provided has always stuck with me and is more eloquent than I could ever be:

> First, they (small firms) are an integral part of the renewal process that pervades and defines market economies. New and small firms play a crucial role in experimentation and innovation that leads to technological change and productivity growth. In short, small firms are about change and competition because they change market structure. The U.S. economy is a dynamic organic entity always in the process of becoming, rather than an established one that has arrived. It is about prospects for the future, not about the inheritance of the past.
>
> Second, small firms are the essential mechanism by which millions enter the economic and social mainstream of American society. Small businesses enable millions, including women, minorities, and immigrants, to access the American Dream. The greatest source of American strength has always been the American Dream of economic growth, equal opportunity, and upward mobility.

The Administration's budget recommendation for FY 2003 is equal to the figure appropriated for the program by Congress for FY 2002. ASBDC and its members are cognizant of the fact that numerous domestic discretionary programs have been recommended for funding reductions this year. ASBDC members understand the impact of declining revenue projections on budget development. We commend the administration for recognizing the significant needs of the small business community in the face of a contracting economy and the terrible events of September 11. The 4% growth in the SBA budget is welcomed. But is it sufficient to meet the nation's needs?

It is important, for this committee to remember that, as a result of the 2000 Census, twenty-four (24) state SBDC programs took serious budget cuts in FY 2002. Those states took cuts, not because they lost population, but because their population did not grow as fast as the national average during the decade of the nineties. For example Mr. Chairman, the SBDC in your home state of Illinois experienced a cut in federal funds of $ 142,108 in FY 2002 compared to FY 2001. The New York SBDC sustained a cut last year in its core federal funding of $ 381,640 compared to FY 2001. It should also be noted that Illinois, New York and Michigan, states which suffered some of the largest cuts in SBDC funding in FY 2002, are states suffering some of the highest unemployment levels in the nation today. It is important to understand that what some refer to as level funding locks in SBDC programs in 24 states at the reduced FY 2002 funding levels. And those reductions came at a time of heightened need.

I know there is concern throughout the small business community at reports that lending authority for the 7(a) program has been reduced by approximately 50 %. SBDC counselors frequently recommend the 7(a) program to clients if they are unable to secure conventional financing for working capital, real estate, or equipment. What the impact of this reduction in loan authority will be on SBDC clients and small businesses generally, I cannot predict. But this level of lending authority is cause for concern.

Everyone associated with the SBDC program, state directors, center directors, counselors and clients were gratified to see that last year's counterproductive recommendations for fees for counseling were not repeated in this year's budget. We believe that OMB heard the views of this committee and its Senate counterpart on the issue of counseling fees. We know that both committees were responding to our clients concerns that at the very time big businesses were being slated for large tax cuts, startup firms were facing the prospect of new taxes, in the form of user fees. It is our understanding that Administrator Barreto has spoken out within the Administration against fees for counseling. We commend him for his action and appreciate his leadership on this important issue.

There is Mr. Chairman language in the President's budget about which there is considerable concern throughout the SBDC program and I am compelled to address it directly. I refer specifically to language on page 351 of the Budget document and I quote, " Measuring the performance of these programs (SBA management and technical assistance programs) has been difficult because many factors beyond SBA assistance affect small business sustainability and growth. **In addition the SBDCs have been reluctant to provide information to SBA"**. I do not know who or what agency is responsible for inserting this prejudicial and misleading language in the Budget document. I do not know whether it was OMB or SBA. But it cannot be allowed to stand unchallenged.

The SBDC program provides SBA with more detailed program activity data, and more detailed economic impact data than any other management and technical assistance program within the agency. This unfortunate budget language appears to be designed to give Congress and the public the impression that the SBDC program is uncooperative in SBA's efforts to measure program performance; that the SBDC program is reluctant to have its performance measured. Such an impression is as false as the very next sentence in the Budget that states, " In fact Congress passed legislation prohibiting SBA from collecting client level information." The first statement I referenced appears designed to mislead Congress and the public. The latter simply reflects the author's lack of knowledge of Congress's activities in this area. It would be enlightening to know who the author was of both of these sentences in the Budget.

As this committee knows full well, the SBDC program has always opposed openly and without apology the collection of the names, addresses and phone numbers of SBDC clients by the SBA in a massive centralized database at the agency. Our clients do not want their privacy compromised in that way. SBDC Board Chair Diane Wolverton, in candid responses to questions before this committee last year made abundantly clear why SBDC clients want and need their privacy protected. Apparently, this committee shared our concerns because it unanimously approved the Velazquez amendment to HR 203. That amendment was crafted to assure the confidentiality of SBDC client information. As members of this committee are aware, the full House overwhelming approved HR 203 last fall.

Mr. Chairman, when SBDC clients come to an SBDC service center, they are given SBA Form 641 or its equivalent to read and sign. I should point out to the Committee that OMB formally approved Form 641. Clients, in signing Form 641, Request for Counseling, acknowledge that they "understand that any information disclosed to be held in strict confidence by him/her."(referring to the client's management counselor). SBDC counselors have always honored that client understanding.

However, in recent years SBA has repeatedly proposed an Entrepreneurial Development Management Information System within the agency. Representatives of the agency have insisted that the system include the names, addresses and phone numbers of all SBDC clients. Explanations by SBA personnel of why such a system was necessary have been varied. Inquiries as to how the information would be used have received widely conflicting answers. ASBDC, SBDC host institutions, SBDC state directors, counselors and clients have always been reluctant, especially in light of the assurances implicit in Form 641, to provide the SBA with client names, addresses and phone numbers. And SBDC personnel are not the only ones who feel this way. It is my understanding that many if not most SCORE counselors share our views with regard to their clients' confidentiality.

SBDC case files, however, are available on site at any SBDC service center for random review by SBA project officers, program managers, program review teams and certification teams in their oversight and management capacity. If the reluctance of SBDCs to assist SBA in creating a centralized database of clients' names addresses and phone numbers is what the budget language refers to, then I acknowledge publicly here today that reluctance. SBDCs, however, to the best of my knowledge have never been anything but forthcoming with regard to data about the activities of the SBDC program, demographic data about our clients or economic impact data. Statements to the contrary are, to my knowledge, without foundation.

ASBDC every two years does a comprehensive survey (the Chrisman study) of the program's long term counseling clients (five hours of counseling or more) and shares that data with Congress and SBA. The latest Chrisman study, conducted two years ago indicated that 49.3% of long-term SBDC counseling clients served during 1998 were pre-venture clients. Chrisman estimates that of that 49.3% who were pre-venture, 54% actually started new businesses during 1998 or 1999.

I am pleased to report to you Mr., Chairman that as a result of negotiations and conversations with officials in the SBA Office of Entrepreneurial Development during the last month, the agency last week acknowledged that it can achieve its informational objectives without having clients' names, addresses and phone numbers in a centralized database. This is a welcomed turn of events.

The Agency has indicated it needs the number of clients served compiled by city, state and zip code. This data historically has been available by state and service center. SBA also wants traditional data regarding gender, ethnicity, etc., broken out by city, state and zip code. ASBDC and its members are prepared to work cooperatively with the agency to achieve these objectives.

Despite the fact that SBA has informed us that they no longer need clients' names, addresses and phone numbers, this committee needs to know that the disparaging statement in the Budget, implying that SBDCs are reluctant to supply data on the program's effectiveness is adversely impacting the program's reputation. The American City Business Journals, which produce business publications in approximately 40 major markets, have carried an article highlighting the language in the Budget and the fact that OMB rates the effectiveness of the SBDC program as " unknown." I have been informed in the last 24 hours that, in response to that article being carried in the New Mexico Business Weekly, a state legislator in New Mexico has called for an investigation of the SBDC program in New Mexico. If OMB truly has doubts about the effectiveness of the SBDC program, then why is this year's Budget recommendation for the SBDC program $12 million greater than the Administration recommended last year?

I would encourage this committee to ask OMB and SBA to document what data they have from SCORE, the Women's Business Center Program, the Micro loan Technical Assistance Program, the Minority Business Development Center Program, the Native American Business Center program, etc, etc., that they do not have from the SBDC program. Ask OMB what data they have from the Minority Business Development Center Program at the Department of Commerce. If, in fact, these other programs have submitted the same or less data, both agencies should be asked why the SBDC program was singled out among management and technical assistance programs for an effectiveness rating of "unknown"

On a more positive note Mr. Chairman, ASBDC and its members deeply appreciate the efforts of this committee to enact HR 3230, the American Small Business Emergency Relief and Recovery Act of 2001. Your leadership, Mr. Chairman, in introducing HR 3230 and moving it through this committee with strong bipartisan support shows what can be done when lawmakers are committed in both word and deed to addressing the serious needs of small businesses in this country. HR 3230 needs to be passed by the House, approved in the Senate and sent to the President for his signature. HR 3230 addresses many of the needs of the small business community. This important legislation would enable SBDCs to address the needs of tens of thousands of additional clients who are experiencing severe business problems brought on by the decline in the economy and the events of September 11. HR 3230 would also enable the SBDC program to assist tens of thousands of Americans who have lost their jobs and who are seeking to stabilize their financial situation through self-employment. As the Bureau of Labor Statistics will verify, when unemployment increases, efforts at self- employment increase. I believe the President's budget included roughly $70 billion for a comprehensive economic stimulus bill. If a comprehensive economic stimulus bill is not going to be enacted, we would strongly recommend that the Congressional budget resolution in the House include adequate funding for HR 3230, which I believe, has been estimated to cost roughly $800 million.

Mr. Chairman, all of us are eager to see the economy turnaround. And there are predictions that recovery may be underway. However, we believe it is likely that unemployment will continue to rise in the coming months. The decline in unemployment for the last month reported may have been a seasonal aberration. A survey released a few days ago by the National Conference of Mayors indicates that 76% of small business owners do not anticipate hiring new employees this year. Those disturbing survey results do not bode well for a robust or swift economic recovery.

There is unquestionably a looming credit squeeze of potentially significant proportions. The Enron scandal, and continued reports of restatements of earnings by large corporations have shaken everyone's confidence in corporate financial statements. This loss of confidence is forcing banks to severely tighten credit. And major lending institutions may well be facing significant loan losses in the months ahead. A roughly seven percent decline in the stock market since the first of the year is impacting the net worth of millions of Americans and will no doubt adversely impact consumer confidence.

The nation is fighting on two fronts. We are fighting a difficult war against terrorism worldwide and we are fighting contraction in the economy. President Bush has presented a budget that proposes spending a little over $2.1 trillion. SBA's budget by my calculation, and I am no mathematician, represents less than 4/100 of 1% of the proposed FY 2003 Federal Budget. Members of Congress are going to have to decide if that is an appropriate allocation of the federal government's financial resources. It is difficult to reconcile the fact that SBA receives only about 4/100 of 1% of the budget when **small businesses** in this country account for half of the nation's gross domestic product, employ 58 percent of the nation's workforce, create an estimated 75% of net new jobs and **according to the IRS account for 44 % of all money collected by the IRS annually.**

Certainly there is no reason to believe that big business will lead us out of the current economic slowdown. The Fortune 500 companies have experienced a net loss of jobs in the past decade. Kmart, once the nation's largest retailer has declared bankruptcy. Enron, once the nation's seventh largest corporation has collapsed. The companies that will be responsible for reducing the nation's unemployment rate, the companies that will put American's back to work and paying taxes will be America's small businesses.

America's corporate conglomerates continue to approach Congress for what some view as unseemly levels of tax relief. Some bills introduced in Congress would provide billions to single companies. Ford Motor Company alone under the economic stimulus package that passed the House last year would have received a tax rebate reported to be as high as $2 billion dollars, more than twice the total budget of the SBA. General Electric, GM and others reportedly were not far behind.

The SBDC program struggles to supply services to a potential customer base of 25 million self- employed on a budget of $88 million in federal funds annually. And yet Department of Agriculture press releases report how a handful of oil seed farmers received direct federal payments of approximately $85 million late last summer. I am not here to bash agricultural subsidies. Production of food and fiber are essential to our national security. But we hear constant statements regarding how these agricultural payments are essential to the preservation of the family farm. And they may well be. If so, that is well and good. But we hear very few statements about the need to preserve the family hardware store, the family pharmacy, the family grocery store, dry cleaners, office supply store, etc. However, when millions of small businesses are facing difficult times, as they are now, the government's current allocation of resources does not indicate a determined commitment to the nation's small business community.

Small businesses need more than simply modest tax cuts. In some instances they may need low interest loans. In the case of those small companies devastated by the events of September 11, they may need grants. Most need expanded management and technical assistance. And virtually all-small businesses need regulatory and tax compliance assistance. That regulatory compliance and tax compliance impose disproportionate burdens on small businesses as compared to larger firms is well documented. In most Departments and agencies a fairer share of resources needs to be directed toward small business. The Energy Star program at EPA is a good example. Only a very modest percentage of that program's resources are focused on the small business community. And it is the small business community that is the least energy efficient. That is not a wise allocation of resources.

Mr. Chairman you will be submitting a letter to the House Budget Committee in the coming days. . I sincerely hope that your letter will encourage the Budget Committee to take a serious look at what small businesses contribute to the Federal Treasury and what they receives in return. Members of this committee clearly understand the problem. However, it is not clear that those in the Executive Branch who write budgets and those in the Congress who write budget resolutions or who craft appropriations bills are as sensitive to the needs of small business as those who serve on this committee.

Certainly small business owners understand that they benefit from a strong military. They benefit from road construction, from spending on health care, etc. But if our government does not allocate adequate resources to the needs of small businesses and offer adequate assistance to the one in ten adults in our economy who are seeking to establish a small business, then our economy will likely face only a moderate recovery at best. And if that recovery is shallow, as many now predict, we will face serious deficits for the rest of the decade and likely beyond. If that occurs, Congress will lack the financial resources to address the health care needs of an aging population. Congress will not have adequate resources for roads and other infrastructure improvements. Congress will be unable to pay for both guns and butter.

Mr. Chairman if an SBDC counselor can help a small business stay viable, there is a clear return on investment to the Treasury. That small business will pay taxes and its employees will pay taxes, taxes that would be lost to the Treasury if the business failed. Moreover, if that small business can be prevented from failing and its employees prevented from joining the ranks of the unemployed, the Treasury will not pay out as much in unemployment compensation, food stamps, Medicaid and other safety net programs. There is meaningful evidence that the true return on investment to the Treasury resulting from SBDC assistance to small firms, if viewed in the terms I have outlined, exceeds the dollars appropriated for the program.

Mr. Chairman we appreciate the efforts this committee has made under your leadership. We noted earlier your leadership on HR 3230 and the committee's approval of that important legislation. We commend you and all the members of this committee for their successful efforts to secure House enactment of HR 203, the Sweeney bill; HR 2666, the Brady bill and HR 2538, the Udall bill. We would encourage all on this committee to encourage their home state senators to help move these important bills through the Senate and to the President's desk for his signature. These and other bills approved and advocated by this committee could make a significant contribution to strengthening the vitality of the nation's small business sector.

ASBDC looks forward to working with you Mr. Chairman, with ranking Member Velazquez and with all the members of this committee to heighten awareness of the contribution small businesses make to the overall welfare of this nation. We stand ready to assist this committee in advocating for adequate budget resources to be directed to meet the needs of the nation's small business sector. ASBDC, on behalf of its members, pledges to this committee, that the SBDC Network will continue to utilize the resources the program receives to the maximum benefit of the clients the Network serves.

Thank you Mr. Chairman for allowing me to appear before this committee today. ASBDC appreciates the committee's consideration of its views. I would be glad at this time to try and respond to any questions the committee may have.

Response for the Record

Administrator Barreto to Mr. Chabot, page 28, line 583

The Small Business Administration (SBA) has never conducted an overall program review or assessment of the Small Business Development Center (SBDC) program. However, in October 2000, the SBA initiated a program review to describe the SBDC delivery system and identify strengths and weaknesses.

"Inconsistency in data definition, collection, and use across the network" is one of the weaknesses identified in the study. An example of data inconsistency affects the ability to make comparisons between SBDC data and national data (U.S. census). One reason is that the national data has more categories (e.g., real estate, health care, food services, etc.) than those provided on the forms completed by the SBDCs. Another reason is the difficulty in categorizing a business. Some may indicate a service when operating a restaurant, and others might designate it as retail trade.

The study recommended that SBDCs "introduce consistency in data quality of program performance information."

Examples of data collected by SBDCs are listed below:

- Number Of Clients Counseled And Number If Training Attendees
- Type Of Business For Clients Counseled
- Number Of Clients By Gender Ownership And Ethnic Background
- Number Of Clients Counseled By Military Status And SBA Client Type
- Number Of Clients By Area Of Counseling Provided
- Categories Of Training Attendees
- Number Of Sessions By Training Topic
- Minimum, Maximum And Average Number And Percentages For SBDC Client Indicators

As part of its ongoing efforts to improve the efficiency and effectiveness of its programs and services (including those provided by its partners), the SBA is evaluating its core programs.

RESPONSES TO QUESTIONS SUBMITTED TO THE SMALL BUSINESS ADMINISTRATION

Question 1: I understand that as part of its effort to correct the continued miscalculation of the 7(a) and 504 program subsidy rates, that the administration considered shortening the lookback period from which a program's subsidy rate would be determined to 10 years but that this idea was rejected? Why?

Each year SBA revises the subsidy rate for each of its programs based on new and updated historical data. This enables us to more closely determine expected program costs.

In the past ten years, the U.S. economy performed better than any time in history. Using only data from those boom years would not represent program performance over a variety of economic conditions. To expect the next ten years to replicate the past ten would be irresponsible.

The subsidy model must reflect the estimated cost of the whole life of a program, not simply its best years. However, in FY2003 for 7(a) we did weight certain data to account for programmatic changes and improvements.

Question 2: Does the SBA use the same lookback period for determining the subsidy rate in each of its programs?

Generally yes. Programs that have reliable data collection systems are required to incorporate all historical data into their calculations. SBA's database has historical data available for analysis starting in FY 1986, which is the start date for the lookback period for the 7(a), 504, and disaster loan programs in analyzing defaults and recoveries. For the remaining programs, including SBIC and Microloan, SBA uses a more limited data set, principally because these programs either do not have usable data back to FY 1986 or did not start until after that date.

Question 3: How many of me 7(a) loans and 504 debentures that were made by year from 1987-1994 are still outstanding? What do they represent in terms of the total dollar volume of loans or debentures made that year? Even though relatively few of those loans or debentures are outstanding you still treat those cohorts equally in the subsidy rate calculation with cohorts later in the decade when many loans made then are still on the books. Please explain why?

The following lists the number and dollar amount of loans outstanding by their original approval year (i.e. cohort), coupled with the original approvals for the years indicated.

7(a) Loans by Approval Year:	# Loans Approved	$ Loans Approved	# Loans Outstanding	$ Loans Outstanding	% # Loans Outstanding	% $ Loans Outstanding
FY 1987	13,139	$2,464,769,221	543	$63,857,614	4.13%	2.59%
FY 1988	13,497	2,678,038,051	685	92,627,832	5.08%	3.46%
FY 1989	14,260	3,019,131,731	857	137,825,166	6.01%	4.57%
FY 1990	15,835	3,549,366,436	1,291	246,522,950	8.15%	6.95%
FY 1991	16,511	3,835,283,660	1,533	303,975,265	9.28%	7.93%
FY 1992	21,159	5,229,097,655	2,816	494,796,391	13.31%	9.46%
FY 1993	23,375	5,933,546,207	3,799	691,372,950	16.25%	11.65%
FY 1994	32,142	7,197,306,991	6,065	1,045,706,960	18.87%	14.53%
504 Debentures by Approval Year:	# Loans Approved	$ Loans Approved	# Loans Outstanding	$ Loans Outstanding	% # Loans Outstanding	% $ Loans Outstanding
FY 1987	798	$168,011,000	163	$14,465,414	20.43%	8.61%
FY 1988	1,063	247,918,000	192	20,933,408	18.06%	8.44%
FY 1989	9,49	242,233,000	177	24,167,098	18.65%	9.98%
FY 1990	1,155	317,403,000	328	56,127,303	28.40%	17.68%
FY 1991	1,352	392,676,000	485	88,742,224	35.87%	22.60%
FY 1992	1,512	439,721,000	852	168,352,196	56.35%	38.29%
FY 1993	1,813	555,400,000	1,251	263,838,882	69.00%	47.50%
FY 1994	2,608	840,317,000	1,884	437,980,408	72.24%	52.12%

As you noted, the subsidy rate calculations do not weight the cohort years by their relative size in the portfolio but are an average of the overall experience of the program. There are many weighting options that are available for analysis but it is often difficult to identify the actual impact of the different variables. The current methodology assumes that on the average, historical performance tends to approximate future performance of a cohort. This 'reversion to the mean' assumption requires equal weighting of all loans issued. However, for the FY 2003 budget model, we weighted Preferred Lender Program (PLP) performance versus non-PLP performance in the 7(a) program because the PLP program has had a discernible -- and expected effect on the 7(a) program.

Econometric modeling can more reliably predict defaults and recoveries since it considers a larger number of factors in predicting program performance into the future. SBA will use this preferred modeling method for the 7(a) program in FY 2004 and for the 504 program in FY 2005.

Question 4: What is the average life, not the average maturity of a 7(a) loan? How about a 504 debenture?

The average life of the 504 portfolio is 13.24 years compared to an average maturity of 19.5 years. The average life of the 7(a) portfolio is 7 years compared to an average maturity of 14 to 15 years.

Question 5: Why aren't you using total loans and debenture activity in a given year as a weighting factor when determining a subsidy rate?

SBA has no reason to believe that the size of the loan program in a given year has any relationship to the anticipated performance of that year's loans. Rather, the performance of the loans is related to many factors, including the program structure, individual borrower characteristics and economic factors. SBA will consider all of these factors in the proposed econometric model that SBA is developing for the 7(a) program in FY 2004 and for the 504 program in FY 2005.

Question 6: SBA's CFO office has testified before this Committee that the actual 7(a) default rate is in the 8-10 percent range. Why is the subsidy rate assumption 12.87? Explain the methodology for determining it. Is it the same methodology you use for the disaster and SBIC programs? If no, why not?

The FY 2003 subsidy rate model for 7(a) included a calculated prediction of the cumulative defaults for 7(a) loans to be made during FY 2003 as a percentage of the original loan dollars disbursed over their entire life, which averages 14-15 years but can be as long as 25 years. This percentage is 12.73%, not 12.87%. Using this factor in the subsidy rate model produced a FY 2003 subsidy rate of 1.76%.

This rate was calculated using a weighting method, in which loans projected to be made under SBA's PLP authority are predicted to perform differently (lower defaults) than those made under non-PLP lending criteria. PLP loans are predicted to have a 11.98% default rate, while non-PLP loans are predicted to have a 13.85% default rate. The PLP rate is weighted at 60%, representing the assumed volume of PLP loans to be approved in FY 2003. The non-PLP rate is weighted at 40%, representing the assumed volume of non-PLP loans to be approved in FY 2003. All available data was used for the look-back period of 16 years (FY 1986-2001) and is used for both calculations. 12.73% is the combined default rate from this calculation.

This projected default rate of 12.73% is over one percentage below the FY 2002 rate and reflects the incorporation of actual program experience for all cohorts in FY 2001 as well as the introduction of the PLP vs. non-PLP weighting methodology introduced for FY 2003 This modeling methodology follows Federal Credit Reform guidelines and takes into consideration an economic time period of good and not-so-good times. Using a shorter lookback period would not be as valid, as indicated in the response to Question 1. A more accurate method can be obtained by using econometric modeling, and, as discussed later, SBA is planning to implement such modeling in FY 2004.

Question 7: Have you ever met directly with the Trustees for the 504 program and received from them the default performance for 504 debentures? Why not? Do the private sector's records of the 504 program's performance match SBA's?

SBA has had continuing interaction with and receives data directly from Colson Services, Inc. (Colson), the Fiscal and Transfer Agent under contract with SBA to provide a range of services, and the Bank of New York, the trustee for the 504 program and Colson's designated depository and banking partner. Data on prepayments and defaults used in the subsidy rate model comes directly from the Bank of New York together with SBA accounting data. Recovery data comes from SBA's internal accounting records.

SBA is confident that the data it uses is consistent with the data used by Colson for the 504 program. However, there are three reasons why confusion regarding the interpretation of data between SBA and Colson might exist. First, Colson tracks performance of the debentures relative to their date of disbursement, while SBA uses the date of origination to track performance. The considerable lag time between origination and disbursement leads to a considerably different view of data under these two methods. Second, Colson tracks performance of the debentures relative to calendar years, whereas SBA uses Federal fiscal years to track performance. As above, this can produce a different view of the data. Third, Colson does not become involved in the Care and Preservation of Collateral (CPC) or the purchase of the first lien position, as SBA must in its servicing and liquidation of defaulted debentures. As such, Colson does not record or have knowledge of the nature of the expenses involved in these transactions, which are a normal part of business transactions to recover debt.

Question 8: What is the gross recovery rate for 504 debentures? What is the net recovery rate? What were these numbers last year? Why is the agency's net recovery rate so poor? After such a poor net recovery rate as reported in last year's budget assumption, what steps has the agency taken to reduce recovery costs?

The collection (gross recovery) rate for the 504 program used in the FY 2003 subsidy rate model is 58.21%. This compares to a rate of 67.27% used for FY 2002.

The expense rate for the 504 program used in the FY 2003 subsidy rate model is 38.24%. This compares to a rate of 40.35% used for FY 2002.

The net recovery rate for the 504 program used in the FY 2003 subsidy rate model is 19.97%. This compares to a rate of 26.93% used for FY 2002.

SBA's subsidy rate models consider all cash flows to and from the Government. As such, SBA must estimate all payments from the Government to the public and all income into the Government over the life of the 504 debenture. A default/purchase is a claim payment from the Government. Likewise, any payments for expenses related to collection and liquidation, such as purchase of a first lien from a lender or CPC (locksmith, appraisals, etc.) are payments from the Government to the public and are estimated in the cash flows. These are offset by income to the Government on the debenture, such as fees, and recoveries on the collateral taken. The cash flows are discounted to the date of disbursement to arrive at the taxpayer subsidy cost. Colson is not involved in all these aspects of the 504 debenture process and so consequently does not account for all cash flow transactions as the government must do.

The net recovery would necessarily be lower than the gross collections because it considers all expenses incurred before, during and after the liquidation process.

A principal component of liquidation expenses is the purchase of the first lien from a lender. In order to ensure that SBA does not unnecessarily purchase a first lien without seeing recovery potential, the Office of Capital Access (OCA) issued guidance to field offices that required that they analyze the transaction from both the expense (purchase) and income (recovery) sides to make certain that the purchase is a wise investment. This ensures that SBA does not purchase a first lien only to find that the ultimate recovery did not even cover the extra outlay of federal funds. As a result, SBA is confident that the purchases that it undertakes are appropriate and are done to maximize recoveries to the government. However, SBA is in constant pursuit of ways to reduce expenses.

Question 9: What assurance is there that SBA is not "cooking the books" and as a result increasing the cost of the 504 program to borrowers by dumping costs unrelated to recovery into the recovery assumption?

SBA is confident that all transactional costs associated with 504 debentures are appropriate. SBA obtains additional assurance of this due to its audit processes. Costs include items such as purchase of a first lien from the lender, CPC expenses (including things like locksmith services, appraisals, payment of taxes or insurance) and any other expense that is needed to maximize ultimate sale recovery of the collateral.

Question 10: Your budget document says you want more 7(a) loans to be made through the 504 program. In fact, a conference call was held with Regional Administrators telling them this when in the current fiscal year, there are no budget constraints or anything else that would warrant this. What is your statutory authority to tell a 7(a) lender it cannot do a loan through the 7(a) program but rather that it must do it through the 504 program? Please provide the committee with any written opinion on this from your Office of General Counsel.

SBA's Budget Request and Performance Plan for FY 2003 states that the Agency "will explore creative adaptations to make the 7(a) program more efficient and effective. Some adaptations SBA is considering include the increased use of the 504 program to finance larger loans for real estate and long term capital equipment investment . . . ." Recent statutory changes in the 7(a) program fee structure, which will be in effect for the two fiscal years beginning with FY 2003, have forced an increase in the expected 7(a) program subsidy rate for FY 2003 from .88% to 1.76%. As a result of the subsidy rate change, the 7(a) program level for FY 2003 would be approximately $4.85 billion. At that program level, SBA anticipates that demand for 7(a) financial assistance is likely to exceed the availability of 7(a) program funds.

In order to help the maximum number of small businesses in their quest to access credit, SBA must ensure that both the 7(a) and the 504 programs are fully utilized at their anticipated program levels in FY 2003.SBA approved approximately $2.3 billion in 504 loans in FY 2001, falling $1.7 billion short of the total loan volume available. If those projects that are more appropriate for 504 are steered toward that program, ensuring the complementary nature of the programs, SBA couldfully utilize both the $4.85 billion requested for the 7(a) program and the $4.5 billion requested for the 504 program. In order to do this, SBA believes that it may be appropriate to encourage borrowers, lenders and Certified Development Companies (CDCs) to utilize the 504 program for fixed asset/real estate loans. [It is important to note that a lender that uses the 7(a) program can also participate on a 504 loan by providing the first mortgage portion of the project financing.]

SBA Headquarters mentioned this concept with the Regional Administrators and said that it was being explored as a possible way for stretching SBA's limited loan authorities. SBA is also considering a number of other possible program modifications that could improve its ability to make more financing available for small businesses without increasing the cost to the taxpayer.

The Small Business Act and the Small Business Investment Act authorizes SBA to provide 7(a) and 504 loans for a variety of purposes, including financing the acquisition of fixed assets, including real estate. SBA's Office of General Counsel is providing legal guidance as the Agency explores its options to make the 7(a) program more efficient and effective. However, there is no written opinion on this subject from the Office of General Counsel.

Question 11: What are your policy objectives with respect to the 7(a) and 504 programs?

The policy objectives for the 7(a) program are contained in its authorizing legislation. The Small Business Act authorizes SBA to provide loans to qualified small businesses for a variety of business purposes. The 7(a) program is intended to provide an alternate source of funding for those small businesses that have the greatest difficulty in accessing financing through the commercial marketplace. Experience has taught us that among those that have such special needs are newly established businesses, businesses requiring small loans, businesses requiring longer term funding, businesses in low and moderate income rural and urban areas and businesses engaged in exporting.

Several years after the enactment of the Small Business Act, Congress took note of the fact that existing loan programs were not adequate to fully address all the funding needs of small businesses that required long-term fixed asset financing and therefore provided additional legislative authority to meet this financing gap. Title V of the Small Business Act authorizes SBA to make loans to foster economic development and to create or preserve job opportunities in both urban and rural areas by providing long-term financing for small business concerns through the 504 program. The statute provides policy objectives for the 504 program and mandates that each project funded under 504 be directed toward at least one of these objectives, including: (1) creating, preserving and retaining jobs; (2) improving the economy of the locality through stimulating business development, bringing in new income and diversifying its economy; and (3) achieving enumerated public policy goals, including business district revitalization, expansion of exports, expansion of minority, women and veteran business development, rural development, enhanced economic competition, changes necessitated by Federal budget cutbacks, including defense related industries, and business restructuring arising from Federally mandated standards or policies affecting the environment or the safety and health of employees.

Question 12: What are your statutory rights in implementing these objectives? What do you need legislation to do?

In implementing these objectives, SBA's authorization is provided in the Small Business Act and the Small Business Investment Act. From time to time, SBA has proposed legislative amendments that it believed would improve program delivery and management, and SBA has worked with the Congress to enact the amendments. SBA is currently preparing a set of legislative proposals to implement the Administration's FY 2003 budget package. SBA looks forward to working with the Congress to implement it.

Question 13: Compared to a conventional loan, what are the additional costs, both direct and indirect, that a 7(a) lender must incur to make a 7(a) loan and what are the additional costs that are borne by a bank and CDC in making a 504 loan?

For a 7(a) loan, a lender incurs the following costs that it does not have on a conventional loan:

- Collecting the ongoing guaranty fee of 50 basis points on regular loans and 25 basis points on STAR loans (loans made to businesses affected by the terrorist activity).
- The guaranty fee, which is an up-front fee charged on the guaranteed portion of the loan based on the loan size. [This fee must be paid first by the lender, but the lender may, and usually does, charge the fee back to the borrower.]
- The cost of processing SBA loan application documentation after the application has already completed the lender's loan application. (Note: this does not apply to SBA Express and Community Express where the lender uses its own documentation.)
- The cost of obtaining IRS and INS verifications that are not required for conventional loans.
- The cost of monthly reporting to SBA on loan status and of sending the ongoing guaranty fee payment to the SBA.

- The cost of collecting and processing the forms that SBA requires but would not be required for conventional loans, such as Form 912, which requests personal history information, including any record of criminal activity.

- For a loan that is processed but never disbursed, all up-front administrative costs that the lender has incurred. [For a conventional loan, the lender typically charges a fee that would cover these costs if the loan is never disbursed. SBA does not allow lenders to charge such a fee.]

In a 504 project, the only direct cost to the first mortgage lender that it would not have on a conventional loan is a .5% fee payable to SBA on the first mortgage. [We understand that this fee is frequently paid for the lender by the CDC.]

Question 14: Are small 7(a) loans and smaller 504 deals more or less costly than the average size 504 deal or 7(a) loan? If the agency wants more, smaller loans to be made, why isn't it working with its lending partners to identify and reduce costs on those loans?

Because the absolute dollar costs may be similar for a small and large loan, the costs as a percentage of the loan amount are higher on a smaller loan. In response to lenders' concerns about the higher cost ratios and borrowers' concerns about the lenders reluctance to make smaller loans, SBA introduced the *LowDoc* and *SBAExpress* pilot programs. Under *LowDoc,* SBA reduced substantially the amount of SBA paperwork that a lender must complete to apply for a loan guaranty for loans up to $150,000. *SBAExpress* took this approach one step further and permits lenders to use their own forms and processes to approve, disburse, service and liquidate loans up to $150,000. In exchange for these authorities, SBA provides a reduced guaranty of 50% on *SBAExpress* loans. Both *SBAExpress* and *LowDoc* loans are processed in centralized processing facilities, with a streamlined approval from SBA (typically less than 24 hours for *SBAExpress* and less than 48 hours for *LowDoc*). These changes in paperwork requirements and processing procedures lessen the staff time required for the lender to receive an SBA guaranty. This reduction in staff time translates directly into reduced costs to the lender.

Question 15: Please report back to the committee in 90 days with what the agency is doing to reduce program costs.

SBA will comply with this request within 90 days as requested.

Question 16: Are the 7(a) and 504 programs delivered uniformly throughout the U. S. or are some areas served better than others?

The use of SBA programs varies by area. In some areas of the country, there is significant competition among 7(a) lenders. In other areas, the market is not as competitive. In addition, some communities have a variety of sources of funding available for small businesses, including state, local and commercial programs as well as the SBA guaranty loan programs. In those areas, SBA may be called upon less frequently to provide loan guaranties.

SBA does not have a standard for determining whether a geographical area is adequately served by the 7(a) program. However, SBA does have a regulatory standard for determining whether an area is adequately served by the 504 program. Under this standard, SBA requires that a CDC approve a minimum of one loan for each 100,000 in population averaged over the past two years for each county it serves. [A list of counties that are not adequately served is maintained on SBA's intranet to assist SBA District Offices in marketing the 504 program to those areas. A copy of that report is attached.]

SBA is reviewing all programs to ensure that they meet the needs of the small business customer and that they are cost effective and customer friendly.

Question 17: What areas of the country are underserved?

Based on the standard in place for the 504 program, about 65% of the counties in the country do not meet the one loan per each 100,000 in population. [A list with the counties in each state and SBA's determination whether the counties currently meet this standard is attached.] There is clearly room for substantial growth in the 504 program. The 7(a) program is delivered by commercial lending institutions. Many of the bank and non-bank lenders that participate with SBA in the 7(a) program operate in wide geographical areas that cross state lines. These lenders, together with local community lenders, provide a good network for providing access to 7(a) loans across the country. Through this lender network, SBA believes that small businesses in virtually all areas of the country have access to the 7(a) program.

However, since only 50,000 out of 25 million potential small business customers take advantage of SBA financing services annually, other markets besides solely geographic might be underserved. SBA is looking to make sure all small businesses, no matter the geographic area or market segment, have proper access.

Question 18: What has the agency done to market the program in those areas? What success has it had? What does it need to do to address the issue?

The staffs in SBA field offices around the country make informational presentations at local meetings of small business owners and individuals seeking to enter business. Agency personnel also make regular presentations at military bases for personnel about to separate from military service. SBA also has an ongoing local and national outreach program to market SBA's loan products to private sector lenders. SBA field offices regularly contact lenders in their districts to ensure that they are aware of SBA programs. As part of this contact, SBA offices provide hands-on assistance and training to lenders that are not familiar with the programs.

District offices conduct an annual training session for the lenders in their area. Staff from SBA's headquarters office attend national trade association meetings as well regional meetings designed to increase lenders' participation in SBA's lending programs. SBA also relies on its network of non-lending resource partners to market its loan programs. For example, the Small Business Development Centers and Service Corps of Retired Executives (SCORE) counselors located throughout the country are familiar with SBA's financial assistance programs and regularly assist small businesses in accessing these programs. Finally, SBA maintains a highly informative website which receives 18 million hits per week so that entrepreneurs seeking assistance get the counseling and other help that they need to start or grow their small businesses.

Question 19: What is your definition of geographically underserved?

SBA has not developed a standard to determine if an area is adequately served for the 7(a) program but is looking at as part of its ongoing examination of its programs. SBA has developed a standard of one loan per 100,000 population averaged over the past two years to use as a guide for determining if a county had adequate 504 coverage. [See response to question 17.]

Question 20: Why can't the Agency get lenders to make more 7(a) and 504 loans in those areas?

SBA is looking at ways to better serve small businesses no matter where they are located. We are looking at new products as well as ways to modify existing products. SBA reaches out to all areas of the country to ensure that lenders are aware of the availability of these programs. The lender determines whether it needs the credit enhancement provided by the government guaranty. Many applicants qualify for a loan on a conventional basis. Others do not qualify for credit even with the assistance of a government guaranty.

Geographic and population density differences make it difficult for SBA to provide a one-size-fits-all approach to outreach and the encouragement of lending activity. In rural areas particularly, the number of commercial loans is limited by low demand for products and services, lack of access to bigger markets, lack of access or added expenses in obtaining raw materials, transportation issues for supplies and finished goods, among other reasons. Lenders willing to serve rural areas are often local community banks because the overall volume of business is not sufficiently profitable for larger regional lenders to incur the expense of providing commercial loans in sparsely populated areas. Also, lender exposure on rural commercial loans is greater because it is harder to sell any commercial assets that may be acquired by the lender if a borrower fails.

Further, commercial lending depends on the judgment calls of both the lender's loan officer and SBA's loan officer, if the loan is processed in a district office. Adding to the complexity is the fact that the economic environment is fluid, always shifting to accommodate changes in demand for products and services which affect the lender's best estimate of whether the borrower will be able to pay back the loan from cash flow.

It is likely that rural local lenders may be more inclined to make loans without a guaranty during good economic conditions because they know the borrower and business personally. In worsening economic conditions they are probably more likely to seek a guaranty because the likely smaller size of their portfolio results in greater sensitivity to exposure on any one debtor.

Question 21: You chose to contract with OFEO to develop an econometric model for the 7(a) program. That is the agency Aida Alvarez headed before joining SBA. Why did you choose it, what are its particular qualifications, who else did you consider, and why did you reject them?

OFHEO has expertise in statistical analysis and econometric modeling based on its government oversight responsibility of Ginnie Mae and Freddie Mac. In addition, OFHEO has on staff Dr. Robert Dunsky, formerly of PriceWaterhouseCoopers, who served as a contractor for SBA on the asset sales program and thus has familiarity with SBA's credit programs. Additionally, using a federal agency like OFHEO is much more cost effective than using private sector firms. SBA also has had a good working relationship with the Office of the Comptroller of the Currency and continues to use its expertise in econometric forecasting.

Question 22: It is quite clear that today's subsidy rate calculations are wrong because of erroneous information fed into the model. Why should Congress expect any difference from the econometric model?

SBA's subsidy model and the data that supports it arereviewed by OMB, GAO, SBA's Inspector General, SBA's internal auditor and a separate external validation firm every year and agree that the approach is reasonable and accurate.

Econometric modeling will improve accuracy in estimating the cost of programs. Econometric modeling is a statistical approach that incorporates all relevant economic and programmatic factors to project future performance. This differs from our current model that only incorporates programmatic factors.

Question 23: How, after years of OMB and SBA presenting us with bogus subsidy calculations for the 7(a) and 504 programs, how are you going to restore intellectual integrity to the subsidy rate calculation process? This isn't a Bush Administration problem-- it occurred in the Clinton administration too. It is an OMB problem.

The subsidy rate calculation is not "bogus." It has been validated by governmental and private sector evaluators. Disagreements among experts do not affect integrity.

Fiscal responsibility is not a partisan issue. The Bush Administration is committed to preventing unnecessary assumption of risk.

Question 24: An apparent objective is to reduce the size of the loan to $175,000. If you are so interested in serving borrowers who need smaller loans, then please explain the agency's rationale for not adequately funding the Microloan Technical Assistance Program?

The Small Business Administration believes that the small businesses who have the greatest need for the 7(a) program are those most historically under-served by traditional credit markets. They are generally businesses who need to borrow $150,000 or less to start or expand their businesses and they are often members of special population groups. In the past few years, the average loan size for the 7(a) program has escalated to a high of $242,000 in FY 2002. Through a focus on small loan products, SBA hopes to be able to reduce the average 7(a) loan size to about $175, 000.

The Microloan program serves the needs of even smaller businesses, those needing loans of $35,000 or less. The Administration's FY 2003 budget proposed funding for the Microloan Technical Assistance program at $17.5 million, the same level of funding appropriated by the Congress for FY 2002. In FY 2001, SBA received an appropriation of $20 million but was unable to use more than $17.5 million to support technical assistance programs.

Question 25A: As an attempt by the agency to make up for its failing to fund the 7(a) Program, you are proposing to make more 7a loans through the 504 program. What is the agency's position on having 7(a) lenders originate 504 loans?

SBA is not failing to fund the program. Congress passed legislation that changed the subsidy rate after budget levels had been set, resulting in a lower 7(a) program level.

To maximize the efficiency of taxpayer dollars, SBA is examining all of its programs to make sure that they are complementary and also serving the needs of small business customers.

Many 7(a) lenders already participate in the 504 program by providing the first mortgage portion of the 504 project (typically 50 percent of the overall project). SBA is very supportive of 7(a) lenders participating as first mortgage lenders in the 504 program.

Question 25B: What obstacles do you see for a 7(a) lender originating 504 loans?

As noted in the response to Question 25(A), many 7(a) lenders already participate in the 504 program by providing the first mortgage portion of the 504 project (typically 50 percent of the overall project). SBA is very supportive of 7(a) lenders participating as first mortgage lenders in the 504 program.

Question 26: What is the justification of using a five-year lookback in the disaster program but looking back to the mid-1980's for the 7(a) and 504 programs? It looks like a double standard to me.

The five year lookback in the disaster loan program is for estimating loan volume, not program performance. That five year lookback is entirely different from the modeling that is performed to determine program cost and performance measures such as defaults, purchases, payments and collections for credit programs. How many years of data is used in the disaster model? I think that could be good to specify.

Question 27: What methodology do you use in determining the SBIC program's subsidy rate? What is the statistical basis for that subsidy rate? What is the role of the so-called experts in determining that subsidy rate and who are they?

Due to the major restructuring of the SBIC Debenture Program and the introduction of the new Participating Securities Program in the mid-1990's, it was determined at that time that a historical subsidy rate model would not be appropriate for these programs. Therefore, at that time, the program experts in SBA's Investment Division assisted in the creation of a subsidy rate model that relied on "expert opinion" to assume various performance characteristics. But what did the "experts" use as a proxy? Again, I don't think this is a full answer. These characteristics covered the major cost drivers in the subsidy rate, such as the level of projected defaults and recoveries. Other program characteristics, such as fees, are determined by statute. However, now that we have some (although limited) experience in the restructured programs, we also incorporate actual program performance into the subsidy estimates.

This model will be looked at in SBA's review of all aspects of programs. Because of limited resources and due to a need to validate a basic model, SBA will be conducting these reviews consecutively rather than concurrently.