SUBSIDY RATE CALCULATION: AN UNFAIR TAX ON SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

WASHINGTON, DC, MARCH 13, 2002

Serial No. 107–47

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE

78–663 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

COMMITTEE ON SMALL BUSINESS

DONALD MANZULLO, Illinois, *Chairman*

LARRY COMBEST, Texas
JOEL HEFLEY, Colorado
ROSCOE G. BARTLETT, Maryland
FRANK A. LOBIONDO, New Jersey
SUE W. KELLY, New York
STEVE CHABOT, Ohio
PATRICK J. TOOMEY, Pennsylvania
JIM DEMINT, South Carolina
JOHN R. THUNE, South Dakota
MICHAEL PENCE, Indiana
MIKE FERGUSON, New Jersey
DARRELL E. ISSA, California
SAM GRAVES, Missouri
EDWARD L. SCHROCK, Virginia
FELIX J. GRUCCI, JR., New York
TODD W. AKIN, Missouri
SHELLEY MOORE CAPITO, West Virginia
BILL SHUSTER, Pennsylvania

NYDIA M. VELAZQUEZ, New York
JUANITA MILLENDER-MCDONALD, California
DANNY K. DAVIS, Illinois
BILL PASCRELL, JR., New Jersey
DONNA M. CHRISTENSEN, Virgin Islands
ROBERT A. BRADY, Pennsylvania
TOM UDALL, New Mexico
STEPHANIE TUBBS JONES, Ohio
CHARLES A. GONZALEZ, Texas
DAVID D. PHELPS, Illinois
GRACE F. NAPOLITANO, California
BRIAN BAIRD, Washington
MARK UDALL, Colorado
JAMES R. LANGEVIN, Rhode Island
MIKE ROSS, Arkansas
BRAD CARSON, Oklahoma
ANIBAL ACEVEDO-VILA, Puerto Rico

DOUG THOMAS, *Staff Director*
PHIL ESKELAND, *Deputy Staff Director*
MICHAEL DAY, *Minority Staff Director*

CONTENTS

HEARING ON SUBSIDY RATE CALCULATION: AN UNFAIR TAX ON SMALL BUSINESSES?

WEDNESDAY, MARCH 13, 2002

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

The Committee met, pursuant to call, at 10:06 a.m. in room 2360, Rayburn House Office Building, Hon. Donald Manzullo (Chairman of the Committee) presiding.

Chairman MANZULLO. 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 attend this hearing. A special welcome also to the Administrator. In case he leaves very, very quickly, which I have noticed, there is a third bambino on the way and that is where he belongs. If he does not leave quickly I will usher you out myself, Mr. Barreto, and take you to the hospital personally to get you there.

We are here today to discuss the subsidy rate calculations for the 7(a) and 504 loan programs. First of all I want to commend the Administration for recognizing the importance of this issue and beginning to correct the problem. We have seen more movement on this issue over the past eight months than over the past eight years. Thanks, in large part, to the personal involvement of Dr. Lloyd Blanchard who left OMB to join SBA as its Chief Operating Officer. Excellent choice and a good move. Good move for the SBA and for the OMB.

The subsidy rate calculation has weighted loans originated by the preferred lenders program more heavily than other SBA loans which dropped the subsidy rate by 20 percent. I appreciate that change.

The Administration is also committed to developing an econometric model for the next budget cycle which is it hoped will provide a more accurate forecast for the performance of the SBA loan portfolios.

I also appreciate the willingness of the SBA to examine other alternatives to make sure that access to the 7(a) program is not cut in half next year.

I look forward to working with the SBA as a constructive partner to see what we can do together.

I wish we had an accurate subsidy rate calculation now so that there would be no question about the availability of the 7(a) program in 2003. Fees could also be reduced in the 504 program. Inaccurate subsidy costs results in overpayment of fees and eliminate flexibility of program delivery. I trust that we will not be in this predicament next year.

Again, I commend the Administration for moving, I believe, very rapidly on this, staying in constant contact with our office. I look forward to this issue being resolved.

I now yield for an opening statement by my good friend and colleague, the Ranking Member, Mrs. Velazquez of New York.

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

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

It should come as no surprise to anyone on this committee that access to capital is access to opportunity. It is the one tenet of business development that holds true regardless of time, place or industry. If entrepreneurs can't tap into credit, the difficult task of starting a business can become insurmountable. That is where the SBA loan program comes to the rescue. With competitive interest rates and a streamlined application process, these programs have been responsible for lending over $10 billion annually, providing 40 percent of the long term capital mix for small business.

These lending programs bridge the gap between affordability and accessibility, creating a partnership with the private sector that is the government's best bargain investment for its money.

Unfortunately, a disconnect in both Democratic and Republican Administrations has limited the reach of these programs. We have the potential to help many more small businesses. This disconnect has translated into an over-charge for both lenders and borrowers of more than $1 billion to date. This is a fact, plain and simple, and it is the most blunt example of the arrogance of our government that I have seen in my service in Congress.

Every year we raise this issue, yet all we hear are excuses. Either the model is not right or more data are needed. There is always an excuse and never a solution. What has been clear is that the OMB in both Democratic and Republican Administrations have been cooking the books in an attempt to hide this Stealth Tax from small businesses, and it taps our nation's entrepreneurs as a cash cow for the U.S. Treasury.

Frustration with this complacency and negligence forced a coalition of lawmakers, including myself, to cut the fees for 7(a) lending in half in order to open up more capital and reduce the cost to small businesses. This move presented the Administration with a golden opportunity to do the right thing and finally report an accurate subsidy rate. Unfortunately, the Administration again chose to play budget games with this year's budget proposal, jacking up the subsidy rate for the 7(a) program to almost double the current level.

The Bush Administration's excuse for increasing what they should have lowered this time was our fee reduction. But if the fee reduction is their excuse, what possible explanation can there be for the 504 program which also saw its fees increase without any substantive rate reduction? This is just one example of the inconsistencies that have plagued this debate.

Another example is all the phony numbers that are floating around. In many cases the figures used to calculate the default rate so critical to the overall subsidy rates are laughable, and are even contradicted by the Administration's own budget. This junk math will taint almost any proposed solution.

The latest excuse we will hear is that SBA has contracted a firm to help construct an econometric model to help more accurately predict true program performance. But given all the phony numbers flowing around, no equation will ever actually report the true cost of the program because if you put garbage in you most certainly will get garbage out.

This is the time of reckoning. Either OMB and SBA report an accurate subsidy rate or we on the Committee working with other like-minded Members will do it ourselves, even if it means taking the money from OMB and SBA to make up the shortfall or making changes to credit reform or even if we have to legislate the subsidy rate every year.

Yes, these are drastic actions, but this problem has gone on for too long to be left unresolved any longer. This change is especially critical at a time when our country is attempting to climb out of a recession. Small businesses make a crucial contribution to this effort. They hauled us out of the last recession into the greatest peacetime expansion on record. They will do it again with our help.

So the question for this Committee and the Administration is, do we fix this problem and provide a $5 billion stimulus to this nation's small businesses to go out and create jobs? Or do we continue the draconian practice of taxing small businesses and keep them from providing the boost this economy so desperately needs?

I know which way I am leaning, Mr. Chairman, and I am pretty sure about you too.

Thank you very much.

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

Chairman MANZULLO. Thank you.

We will start with Nancy Dorn who is the Deputy Director of the Office of Management and Budget. Normally we would start with the Director, but this is the preference so that your testimony will sequence into the next, is that correct?

Ms. DORN. That's correct.

Chairman MANZULLO. I look forward to your testimony.

All the statements of the witnesses and the Members of Congress will be made part of the record.

Please.

STATEMENT OF THE HONORABLE NANCY DORN, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Ms. DORN. Thank you, Mr. Chairman, and good morning.

Chairman Manzullo, Congresswoman Velazquez and Members of the Committee, I am Nancy Dorn, Deputy Director of the Office of Management and Budget. I am pleased to be here today to discuss OMB's role in implementing the Federal Credit Reform Act of 1990. It is in this capacity that OMB worked with SBA on cost estimations for loan programs.

Before I begin let me say that it is unfortunate that the premature release of preliminary and incomplete estimates for SBA's 7(a) business loan program may have led to unrealized expectations. I would like to point out that our efforts to improve the accuracy of the subsidy rate calculation, the first such effort in over a decade, resulted in a 20 percent reduction in cost. The Administrator will explain in further detail the steps that OMB and SBA took to improve the methodology and the progress made in developing an econometric model for use in the fiscal 2004 budget.

While the Administration recognizes the importance of SBA's lending programs, we feel that the best way to address the needs of small business is through sound tax and regulatory policy. Reductions in individual taxes benefit the approximately 20 million small businesses who pay taxes at individual income rates. In addition this Administration is committed to reducing the financial and administrative burden on small businesses, complying with tax, environment, health and labor regulations which again benefit the vast majority of the nation's 25 million small businesses.

To address the lending needs of small businesses affected by the September 11th attacks, the Congress passed and the President signed legislation to temporarily lower fees for SBA lending programs and transfers from the rest of the government. While the fee reductions may help those businesses and lenders that participate, it also means that the subsidy rate and the cost of these programs rises. Given the additional costs, the budget supports a 7(a) loan volume that's lower than the 2002 loan volume even with an increase in appropriations for the basic 7(a) program.

With respect to the fiscal 2003 budget, the increase in the subsidy rate for the 7(a) program is not the result of any Administration proposal. However, we believe that there may be opportunities to leverage additional lending in other SBA programs to offset the decreased loan volume in the 7(a) program.

I would like to speak for just a minute about the Federal Credit Reform Act since that is one of the main reasons that OMB is involved in this process.

As you know, the Federal Credit Reform Act became effective in fiscal year 1992 and it required federal agencies to accurately measure the true cost of lending programs by budgeting up front for the expected net loss to the government.

Prior to that time the cost of federal loan programs was very uncertain and in many instances it took years for the costs to become apparent. Loan defaults and guarantee claim payments were reflected in the budget years after loan disbursements and guarantee commitments had been made.

The cost of interest subsidies was clear only after several years of experience with market interest rates. The cost of direct loans was systematically over-estimated and the cost of loan guarantees systematically under-estimated. Credit reform, federal budgeting, and accounting for credit programs on an equal footing by requiring that the cost of loan programs be calculated and recorded up front in the years that the loan is made or guaranteed. It takes the best information available at a given point in time to measure the budget impact of federal loan programs. It uses the actual historical cash transactions of loan programs to compare the net present value of payments by the government with the net present value of receipts. This allows policymakers to make more informed decisions about credit programs and to compare more accurately the budget impact of credit programs with other federal expenditures.

Consistent with the Budget Enforcement Act agencies must also use the technical assumptions derived at the time of the budget's release for budget execution which means that they must use the default and recovery rates, the discount rate, and other relevant assumptions as provided in the budget for that fiscal year. This protects the integrity of the analysis and protects the loan volumes provided by Congress by removing or changing the subsidy rate estimate during or after the appropriations process.

Credit reform also requires that legislative changes to the subsidy rate be scored accordingly. Under credit reform agencies must update their subsidy estimates each year to reflect the accurate performance and experience in loan programs. Programs that experience higher costs than projected generate upward cost re-estimates and therefore require an additional mandatory appropriation from the Treasury to cover those losses.

Programs experiencing lower costs and projections generate downward cost re-estimates and therefore return excess funds to the Treasury. These re-estimates do not require further action in the annual appropriations process.

The Federal Credit Reform Act gives OMB the authority to make subsidy estimates. We have in most cases delegated that authority to the agencies but have retained the right to review and approve all estimates submitted by the agencies as part of their budget formulation and execution. We take this role very seriously at OMB. The staff works to ensure that estimates have been calculated in accordance with the requirements of the Federal Credit Reform Act and the applicable guidance issued by OMB, Treasury, the Financial Accounting Standards Advisory Board and other entities.

A large part of this role is ensuring that consistent standards are applied. To help agencies meet these requirements OMB's developed a number of tools to estimate and re-estimate the cost of credit programs as well as spreadsheets to assist in the end-of-year calculations. We have also provided detailed training on credit budgeting concepts and applications.

Chairman MANZULLO. How are you doing on time?

Ms. DORN. I am about out.

Chairman MANZULLO. Can you conclude there, or can you get to——

Ms. DORN. Yes, sir. Let me just say that from our perspective we have a good working relationship with SBA. We have worked very closely historically on these subsidy estimates. We understand that the Congress is concerned about the current situation and we look forward to working both with the SBA and with the Congress to look for ways to alleviate the stress on the system.

I look forward to answering any questions you may have.

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

Chairman MANZULLO. Thank you.

Mr. Barreto.

Mr. BARRETO. Thank you.

STATEMENT OF THE HONORABLE HECTOR V. BARRETO, JR., ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION

Mr. BARRETO. Good morning, Mr. Chairman, Ranking Member Velazquez and Members of the Committee. Thank you for this opportunity to discuss the subsidy rates for the SBA's credit programs. I hope that my testimony and our discussion that will follow will clear up some of the misconceptions regarding the models and assumptions we use to calculate these rates.

First of all, please allow me to explain——

Chairman MANZULLO. Administrator, excuse me. We just heard the call for the vote. My preference would be for us to go vote and then come back right away. Would that be okay with you?

Mr. BARRETO. That would be fine, sir.

Chairman MANZULLO. We will be back in about ten minutes. Thank you.

[Off the record for a vote from 10:26 to 10:34 a.m.]

Chairman MANZULLO. Administrator Barreto, do you just want to start over?

Mr. BARRETO. Whatever you would like, sir.

Chairman MANZULLO. We got your name. Why do you not proceed from there. Thank you.

Mr. BARRETO. Thank you, Mr. Chairman, Ranking Member Velazquez, and Members of the Committee. Thank you for this opportunity to discuss the subsidy rates for the SBA's credit programs. I hope that my testimony and our discussion that will follow will clear up some of the misconceptions regarding the models and assumptions that we use to calculate these rates.

First of all, please allow me to explain what a subsidy rate is. The subsidy rate represents the amount of appropriations necessary as a percent of total loan volume to cover the projected loan default for a cohort of loans made in a single fiscal year. It is calculated by finding the net present value of cash flow to and from government over the life of the loans made in that year.

A simple equation that defines the subsidy rate would set the subsidy rate equal to cash outflows minus cash inflows. The loan defaults purchased by SBA represents the cash outflows. The cost is offset by the cash inflows which include up front fees from the borrower, ongoing fees from the lender, and whatever we can recover from the purchase default which has amounted to about half of all defaults.

In general, higher fees and lower defaults reduce the subsidy rates and lower fees and higher defaults raise the subsidy fees.

I understand your concern why the SBA's calculation of the subsidy rates for the 7(a) and 504 programs has seemed inconsistent with actual performance. Nevertheless the subsidy rates reflect SBA's average historical performance.

The challenge we face, however, is looking into an uncertain future and predicting the average loan performance for the next cohort of loans for each year of life for that cohort. Doing so is akin to predicting the average test score performance for the next class of kindergartners for each year that they are in school all the way through high school, 12 years into the future.

One approach is to predict the 13 average annual scores by using the data from the past year's average scores in grades K–12. This approach is essentially the same one we have been using to estimate loan performance. We take past performance from the last 16 years to predict how the next cohort of loans going forward for 15 to 20 years will perform.

To focus more on the 7(a) program, Mr. Chairman, I realize that for nine of the past ten years we have experienced net downward re-estimates in the 7(a) program during what proved to be the most extraordinary period of economic expansion in our country's history. Just as the stock market grew faster than the underlying fundamentals warranted, this same phenomenon caused the SBA to similarly underestimate the performance of its loan portfolio.

The issue in retrospect becomes whether the SBA should have followed the path of irrational exuberance in forecasting over that which Chairman Greenspan showed such concern or whether we should have stayed the course and continued to rely on fundamentals. I believe that the SBA followed the more prudent course by relying on fundamentals.

From 1993 to the present fiscal year the subsidy rate for the 7(a) program was successfully reduced from 5.21 percent to 1.07 percent based on historical experience.

For fiscal year 2003, SBA executed a new interim calculation method which weights preferred lender loans more favorably than non-preferred lender loans with improved methodologies based on SBA's data to reliably delineate the default experience of the two programs.

The subsidy rate was consequently lowered by one-fifth, all the way to .88 percent which at the President's $85 million request for 7(a) budget authority would have funded $9.7 billion in lending.

The President's plan was to provide record levels of lending to small businesses. However, P.L. 107–100 subsequently reduced the fees paid by borrowers and lenders for a two year period beginning in October 2002 causing the subsidy rate to double to 1.76 percent.

Since this legislation doubled the cost of providing 7(a) loans the President's request of $85 million can only fund half as much in 7(a) lending. Nevertheless the SBA is continuing to create a more accurate method of calculating the subsidy rate.

We work closely with the General Accounting Office and the Office of Management and Budget to determine the best way to incorporate historical data in calculating subsidy rates. While GAO ultimately disagreed with the interim method chosen by SBA and OMB, both GAO and OMB agreed with SBA that the econometric approach is the best method to use.

We all agreed that a sound methodology adequately addresses economic fluctuations and programmatic changes while remaining unbiased, producing subsidy estimates that are just as likely to be revised upward as they are downward over a long term period of time. An econometric model is a more sophisticated weighting method than the PLP weighting model as it creates a way for each relevant factor and estimates the subsidy rate based on the relative strength of these weights.

I am confident that our implementation of the econometric model in fiscal year 2004 will resolve many of the concerns you have. It is a proven model. As I stated, OMB and GAO both agree that it is the most appropriate method to use and other federal agencies, including the Federal Housing Administration and the U.S. Department of Education already use it to calculate the subsidy rates for their credit programs.

To implement the model the SBA has contracted with the Office of Federal Housing Enterprise Oversight or OFHEO, an agency which uses such a model to monitor the housing credit markets and the performance of mortgage loans.

Mr. Chairman, Ranking Member and Members of the Committee, thank you for the opportunity to appear here today. I will be happy to answer any of your questions.

Thank you.

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

Chairman MANZULLO. Thank you.

Our next witness is Christopher Crawford who is the Executive Director of the National Association of Development Companies. We look forward to your testimony, Mr. Crawford.

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

Mr. CRAWFORD. Good morning. I am pleased to again come before the Committee to comment on the SBA 2003 budget model and subsidy assumptions. I would like to thank you Chairman Manzullo, Ranking Member Velazquez and the Committee for convening this hearing.

The 2003 budget adds to the injustices of the past budgets by again forcing our borrowers to pay millions of dollars in fees to the U.S. Treasury. It appears it will take this Committee's oversight to motivate the Administration to stop using these loan programs to cover deficits.

This budget increases the annual fee charged each 504 small business borrowers from .410 to .425 percent. The program is supposed to pay for itself through these fees, and it does this and far more.

Since we went to zero subsidy in 1997 borrowers have paid the Treasury $400 million in excess fees and interest according to SBA's own re-estimates. Even paying fees over and above these inflated cost estimates the Administration demands still more from small business by increasing the fee for 2003. This is truly an unwarranted tax on our borrowers.

This fee increase is caused by errors we believe SBA and OMB are making in their assumptions and their forecasts.

First, the estimate of loan defaults is 8.3 percent. Attached to my statement that you have been provided are charts that show loan defaults for the past 12 years are nowhere near eight percent.

The President's own budget supports our estimates, not SBA's forecast.

Page 49 of the budget request and performance plan admits the true defaults are running $60 to $70 million annually, at an annual volume of $2 billion or more defaults are averaging under five percent.

Second, SBA loan recovery forecasts do not match actual performance through the asset sales or our CDC liquidation program. They forecast collection of 58 cents of every dollar on defaulted loans. However, SBA also forecasts they will spend 38 cents to make that recovery leaving a net recovery of only 20 cents of each dollar.

Our CDC liquidation program has averaged 55 percent recovery since it began some three years ago. At the same time SBA states they are recovering 50 percent for loans sold through their assets sales.

I have to ask you, where did the money go? It did not go into the recovery expenses for either the liquidation program or the asset sales since neither program has substantial operating costs.

Third, we believe SBA is using erroneous forecasts of future loan prepayments. We are funding 504 loans today at a record low market rate, often below six percent. Even with servicing and SBA fees added on, borrowers will obtain long term rates that they are not likely to want to pre-pay in future years. I believe pre-payments will in fact go down, not increase for this cohort.

Finally, even the SBA recognizes that they are not doing a good job of forecasting our portfolio performance yet their solution is to change the subsidy models rather than improve their data analysis. They plan to spend the next five years building and debugging a new econometric model that was actually created to reflect housing costs, not commercial lending costs. This process will consume time, money and resources to get it right and give the Administration further excuses for continued subsidy errors.

Our subsidy problems have led to inflated fees and has made 504 truly a Treasury cash cow as Ms. Velazquez pointed out. Borrowers are paying hundreds of millions of dollars in excess fees and are now told that they are going to pay even more for the 2003 cohorts.

We strongly object to this budget proposal 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 our small business borrowers will continue to pay excessive fees for years to come.

Thank you for this opportunity to provide comments.

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

Chairman MANZULLO. Thank you.

Our last witness is Anthony Wilkinson, President and CEO of The National Association of Government Guaranteed Lenders.

Mr. Wilkinson.

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

Mr. WILKINSON. Thank you, Mr. Chairman, Ms. Velazquez, and thank you for holding today's hearing.

As we all know, users of SBA loan programs have been substantially overcharged the last decade. In the case of the 7(a) program OMB admits through the budget process that the overcharge or the downward re-estimate in the 7(a) program totals $1.429 billion. I have listed these downed re-estimate amounts on page one of my written testimony.

On page two of my written testimony is another page that discloses that OMB has not been forthcoming in the re-estimate process. This shows that OMB requires the use of rates in the re-estimate process that are higher than what is statistically expected. Had OMB used the expected default rates in the re-estimate process they would recognize an additional $400 to $600 million in downward re-estimates in the 7(a) program. This would bring the total overcharge to approximately $2 billion and it was $2 billion that OMB's representative admitted to at the Senate Roundtable discussion that was held last September. That is $2 billion since the start of credit reform in 1992, or on average a $200 million per year overcharge.

Now let us take a look at the current year. OMB is estimating defaults at 12.73 percent, a number that has not been seen over the last decade. We know from the Senate Roundtable last year that SBA had recommended using a five year look-back period, a method that SBA believes would have been more predictive of near term loan performance. OMB rejected this, and OMB rejected each of the other six methods that were proposed, deciding to stick with the method that provided the highest default estimate and hence the highest costs to 7(a) program users.

In a previous hearing before this Committee SBA testified that the default rate for the 7(a) program was being managed in the eight to ten percent range. If OMB were to use a more realistic default assumption for fiscal 2003 we believe the subsidy rate would fall by approximately 100 basis points or one percent. That would leave a 7(a) subsidy rate of approximately .76 for fiscal 2003 and we would need appropriations of about $91 million to meet the anticipated demand for next year.

Now considering the $2 billion that has been overcharged, users of the 7(a) program have already sent enough money to the Treasury to fund the next 20 years worth of 7(a) loans. That is just not reasonable.

Mr. Chairman, NAGGL has repeatedly said that we do not care what model OMB uses in calculating subsidy rates but we do believe the resulting calculation should be fair and reasonable. We have never demanded that it be totally accurate, just reasonable.

We believe that there should be an equal likelihood that the re-estimates could be revised upward as well as downward.

It is obvious that the calculation to date has not been fair or reasonable. OMB has been levying taxes on 7(a) program users. We start fiscal 2003 with a default estimate of 12.73 and we know we are going to have a down re-estimate as soon as the year ends. The same thing is going to happen for this current fiscal year because they used a default estimate of 13.87, so we will have a downward re-estimate.

I direct your attention to the subsidy rate re-estimate for loans that were originated just in fiscal year 2001. OMB says that the subsidy rate has already fallen by 40 percent, from 1.17 to .71 during the fiscal year. Many of the loans approved in fiscal year 2001 had not even been disbursed by the time they figured out they have over-estimated the cost of loans made in fiscal 2001.

In Mr. Barreto's testimony today he cited that all but one of the years there had been downward re-estimates in the 7(a) program. The very first re-estimate in 1995 was an upward one. OMB used this upward re-estimate to pitch the need for higher fees in 1996. Unfortunately, we had to go along so in 1996 the 7(a) program incurred a huge fee increase, one that we know now was not needed. As a result of the 1996 fee increases many lenders over time exited the program. Fortunately Congress saw how OMB was taxing 7(a) program users and you passed fee reduction legislation last year. That legislation eliminated only about half of the 1996 fee increase that was not needed. Hopefully we can consider further cost reductions and hopefully get the ratio of downward re-estimates to appropriations down to ten years rather than the current 20.

Lastly I would like to share our concerns over the move to the so-called econometric model. The current model used by SBA is a simple net present value cash flow model. It is fairly easy to understand. But the 7(a) subsidy calculation is not driven by the model, it is driven by the assumptions plugged into the model. OMB could have easily had a subsidy calculation that was fair and reasonable simply by adjusting assumptions. They had recommendations from SBA and GAO and they chose to ignore them.

We believe an econometric model will be much harder to understand, one; and two, will have many more factors that will be driven by OMB assumptions.

To put it in simpler terms, we have cracked the old black box and figured out what OMB was doing. But now they plan to build a new black box so they can continue to overcharge users of the program.

Mr. Chairman, OMB has not been held accountable for the decisions they make in the subsidy calculation process and until they are we fear the overcharges will continue. OMB had every reason to adjust its assumption in the fiscal year 2003 budget. There were mandates from both the Senate and House Small Business Committees, Republicans and Democrats alike. There was report language in the fiscal 2002 Treasury Postal Appropriation Bill and I can go on and on. Let me just say they chose to ignore it all.

Instead OMB tries to shift the focus of the discussion away from them and talk about how Congress is to blame for the fiscal year 2003 budget shortfall and how we should all wait another year while they build their new black box.

Mr. Chairman and Members of the Committee, SBA program users need your help. It is clear they have been taxed by OMB. It is clear that OMB has not had any desire to fix this problem. They have made mockery of the Federal Credit Reform Act and as a result have made the appropriation process very inefficient.

It is time, this fiscal year, right now, for a solution. We believe OMB accountability has got to be a big part of that solution.

Thank you, Mr. Chairman.

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

Chairman MANZULLO. Thank you all for your testimony.

I have just a couple of questions of Nancy Dorn.

I do not know if I heard this right, but maybe it is reflected on page two of your statement under, see where it says federal credit reform about a third of the way down, the heading?

Ms. DORN. Yes, sir.

Chairman MANZULLO. It says the Federal Reform Act—Wait a second. I'm sorry. I am on the first page.

The first page, second full paragraph. 'Before I begin'.

Ms. DORN. Right.

Chairman MANZULLO. 'Before I begin let me say it is unfortunate that the premature release of preliminary and incomplete estimates for SBA's 7(a) business loan program may have led to realized expectations.' Unrealized expectations.

Can you explain what you mean by that? I guess first I have to read it right, but can you explain what you mean by that?

Ms. DORN. Mr. Chairman, I think there was some confusion in the last year. This was certainly before I came to OMB, but I think there was some confusion last year about what the calculations that SBA and OMB were going to lead to in the subsidy rate. I think there was some thought that we were going to reduce the subsidy rates but that the reduction would be greater than what it turned out to be.

Chairman MANZULLO. What caused that? Mr. Blanchard, were you familiar with what happened there? Did you want to comment on that?

Mr. BLANCHARD. Yes, sir.

Chairman MANZULLO. That was before Mrs. Dorn's tenure.

Mr. BLANCHARD. Yes, sir, Mr. Chairman. I am familiar with what happened.

The staff members of the House and the Senate Small Business Committees were eager to learn what the subsidy rate would be using this new model for 2003 before we actually completed the budget and the estimation of this rate.

At the time, sir, I was at OMB working on this particular issue and——

Chairman MANZULLO. You briefed us in our office on this, too.

Mr. BLANCHARD. Yes, sir.

I resisted providing a point estimate of what that would be because we simply did not know. We had preliminary analysis. We had done that to try to see whether this model, this new interim model would actually perform as well as we think it is performing. But at the time I was being pushed by staff members to provide some kind of estimate just so they could have a sense of where it would be.

In my haste I gave them a range of estimates just to satisfy them, really trying to be forthcoming with information and to work closely with our legislative partners in providing that range, sir. That was then taken as fact. They sort of banked on that, so to speak. I think that banking led to some preliminary calculations for the Senate Bill 1196 that——

Chairman MANZULLO. Did that have anything to do with the estimated amount of so-called budget surplus?

Mr. BLANCHARD. I am not sure what you are referring to with regard to the budget surplus.

Chairman MANZULLO. In other words, when the subsidy rate is set, or calculated, does that have anything to do with the general gross revenues that come into the government?

Mr. BLANCHARD. The subsidy rate does indeed have something to do with that—As Administrator Barreto mentioned earlier in his testimony, the subsidy rate is essentially a prediction of the appropriations that are necessary to cover defaults. Without knowing what those defaults would be, we simply make a prediction. As time goes on we learn more about that default behavior and then we adjust what is held in the account to cover those defaults. So it adjusts upwards and downwards. Unfortunately the adjustments have been such that it has created this surplus that has gone back to the Treasury over——

Chairman MANZULLO. You answered about 80 percent of the question. Let me follow up and maybe get more particular.

Does the estimated amount of surplus in general revenue of the government have anything to do with calculating the subsidy rate?

Mr. BLANCHARD. No, sir. Not at all.

Chairman MANZULLO. Totally separate.

Mr. BLANCHARD. Yes, sir.

Chairman MANZULLO. The reference that Ms. Dorn made to the premature release of preliminary and incomplete estimates for SBA's 7(a) business loan programs, that was reference, Dr. Blanchard, to a September 5th Roundtable that you had had with the Senate?

Mr. BLANCHARD. No, sir. Actually that was subsequent to that Roundtable.

Chairman MANZULLO. Because at that Roundtable, that is where you had said the history of this program is one that has had an unfortunate one. 'The Administration has worked in its first year to correct this problem and it is one that we inherited that as you have all mentioned is a serious problem. WE recognize that over the past 10 to 12 years there is a cumulative $2 billion that has gone back to the Treasury.'

The last part of that is correct, is it not? The accumulated——

Mr. BLANCHARD. I actually do not think that is correct. I believe it is $1.4 billion as Mr. Wilkinson referred to in his testimony.

Chairman MANZULLO. $1.4 as opposed to $2 billion.

Mr. BLANCHARD. Correct.

Chairman MANZULLO. Because you did not have the figures in front of you at the time and I can understand that. That must have been the case.

Mr. WILKINSON. I would add on to that, there was a sheet in my testimony called Unweighted Purchase Rates that goes through the rate they use in the re-estimate process, yet the rate that they expect in terms of defaults are much lower than they are using in the re-estimate process.

So while $1.429 billion has been recognized, it is anticipated there is going to be another $400 to $600 million that will be downward estimated in the future.

Chairman MANZULLO. Thank you.

Let me give you a very simplistic situation here. I am not into macroeconomics, I am into microeconomics. If you are the one that loses your job you could care less about whether or not the rest of the neighborhood is working.

Let us take a look at a loan that goes to A Corporation, and let us say this loan is $100,000. Figure for me, and you do not have to give the exact figure, but work through with me how you would figure the subsidy rate just on this one loan. However you want to do it. Explain the elements and kind of give me a rough idea.

Mr. BLANCHARD. Okay.

The subsidy rate is calculated before loans are made. What we are trying to do is estimate for fiscal year 2003, when we make that $100,000 loan and many more of those loans, what will be the default rate?

Chairman MANZULLO. You want to set aside a pocket of money to cover what could be a loss.

Mr. BLANCHARD. That is right.

Chairman MANZULLO. That is really what the subsidy rate is. Okay, go ahead.

Mr. BLANCHARD. That is right.

Based on the historical performance of loans of similar sorts, we estimate in advance what that default would be. Not only in the first year of that loan, but in the first, second, third, and throughout the life of the loan.

Chairman MANZULLO. With regard to the 7(a) and the 504 programs, are there different categories of default? Is it based upon the nature of a business or is everything lumped together in the 7(a) and the 504?

Mr. BLANCHARD. As it has been calculated in the past up to FY 03, all 7(a) loans have been treated the same in that calculation and all the 504 loans have been treated the same in that calculation.

Chairman MANZULLO. Then on the first element, the default rate, I am trying to find out where there are areas of agreement and where there are areas of disagreement, and maybe that is where we can hone in.

Is there disagreement as to the default rate that occurs with these loans?

Mr. BLANCHARD. Yes.

Chairman MANZULLO. Not a very good start, is there.

Dr. Blanchard or Administrator Barreto, however you want to do it. Let us take it element by element and let us see——

Mr. BLANCHARD. We disagree in what the default assumption should be, sir.

Chairman MANZULLO. Okay. Walk me through that.

Mr. BLANCHARD. Our estimate of the default rate is based on the average performance of all of the loans that have been made from 1986 to the present date, so data up through 2001.

Chairman MANZULLO. Mr. Wilkinson, what is yours based on?

Mr. WILKINSON. The performance of the program since——

Chairman MANZULLO. What do you think it should be based on, sorry?

Mr. WILKINSON. Since the start of credit reform, when credit reform started there were substantial programmatic changes. The program that existed in 1986 is not the program that exists today.

Chairman MANZULLO. Why is that?

Mr. WILKINSON. Lenders have a much greater investment in the loans today, the guaranteed percentages have declined, the lenders have to pay an ongoing fee that was not there in 1986. So there is a much greater financial interest of the lender in the loan program today.

Chairman MANZULLO. Do you agree with that, Dr. Blanchard?

Mr. BLANCHARD. I do agree that the program has changed, which is precisely why we are weighting the PLP loans differently than the non-PLP loans for fiscal year 2003.

Mr. WILKINSON. The default rate that they attach to PLP loans is higher than any default rate we have seen since 1991. They are using 11 point, it is over 11 percent default for PLP in the weightings they are using this year and anticipated defaults in the 2000 cohort is 8.1.

Chairman MANZULLO. So Dr. Blanchard you are going back to 1986 and you are averaging all the loans since that time to come up with the——

Mr. BLANCHARD. That is correct.

Chairman MANZULLO. You are saying that about 11 percent of the loans that default or 11 percent of the amount of money loaned has been in default?

Mr. BLANCHARD. We are saying 11 percent of the SBA's portion of the outstanding——

Chairman MANZULLO. Okay. It is based on money, not the numbers of the loans.

Mr. BLANCHARD. That is correct.

Chairman MANZULLO. Mr. Wilkinson, what is wrong with that average?

Mr. WILKINSON. First of all they do a simple average. There were some——

Chairman MANZULLO. I prefer to keep things simple. That is why I am going through this step by step. But what is wrong with simple average?

Mr. WILKINSON. First of all, it is an arbitrary point in time. They picked in 1986 because that is where they start with their data.

Chairman MANZULLO. Dr. Blanchard, he said that 1986 is an arbitrary date.

Mr. BLANCHARD. Sir, we have a chart that can help illuminate it a little more easily.

Chairman MANZULLO. That would be fine.

Mr. BLANCHARD. This takes us down into averaging. Let me set up the chart.

Chairman MANZULLO. Mr. Barreto, I did not mean to ignore you, I just left it up to you as to who would answer the question.

Mr. BARRETO. I brought my expert this time.

Chairman MANZULLO. That is fine.

Mr. BLANCHARD. Mr. Chairman, we thought that you might want to know precisely how this model works, so we built a graphic that walks you through the cash flow model.

Now it is important to recognize, sir, that the projection of the default rate is something that we do outside of this model. As our industry partners mentioned earlier, the main assumption is the default rate.

Without knowing what the default rate will be in the future, the best evidence we have is that of the past. What we are going to do in the future with regard to our calculation method, the econometric model will calculate the default rate. What you do is separate the estimation of the default from the estimation of the subsidy rate. The default is an assumption that drives the subsidy rate.

Chairman MANZULLO. The reason I went through that is I thought I would be a nice guy and try to find certain areas where people agree on getting to this.

Before you do that, Dr. Blanchard, is it the default rate that is the most contentious of the four items in here?

Mr. BLANCHARD. Yes, sir.

Chairman MANZULLO. Then I guess I started with the right one.

Mr. BLANCHARD. You sure did.

Chairman MANZULLO. How do you want to do that?

Mr. BLANCHARD. As you see in front of you there are basically three components to that. Obviously taxpayers pay taxes into the Treasury so that is an important component on the back end. But the outflows, remember that the basic equation here is that the subsidy rate equals the cash that goes out minus the cash that comes back in. The cash that goes out, the only cash that goes out in these loan programs are our purchase of the defaulted loans.

This number says that our expected default rate is 8.2 percent. This is of all outstanding loans. This number is equivalent to the 12 percent assumption that Tony mentioned that is a proportion of SBA's guaranteed portion. I do not want to confuse anybody. But that sets the outflows.

Then we collect fees from the borrowers, we collect fees from the lenders, and then we recover some of those defaulted loans. You see the arrows point to that outflow and inflow. That then tells us how much money we have to set aside in the form of appropriations to pay for the rest of the program. That is all this model shows you, sir.

You see that the arrows and the numbers that are attached to them are also maps to the equation at the bottom of that page.

Chairman MANZULLO. Mr. Wilkinson, do you have a problem with this chart? Or just with the assumption of the default rate?

Mr. WILKINSON. It is the assumption of the default rate. The arrows are right. That is how the cash flows in and how the cash flows out.

Chairman MANZULLO. Okay.

Tell me again, why you think that? What Dr. Blanchard is telling us is that they go back to 1986 and take the average default rate of the amount of money SBA puts out.

Mr. WILKINSON. It is a simple average going back to 1986. It ignores the program changes that have occurred since 1986.

They have testified that this program is being managed in——

Chairman MANZULLO. What are those program changes since 1986 that you think should do away with simple averaging?

Mr. WILKINSON. Fees have gone up, lenders have seen the guarantee percentage decline. Remember, there was a point in time there was 90 percent guarantee. The average guarantee since 1986 has gone down.

So again the lender has more at risk in each of these deals.

Chairman MANZULLO. Let me stop you right there.

Dr. Blanchard, those two elements he just put in, why should they not be figured into the simple averaging?

Mr. BLANCHARD. Before the calculation for the model in 2003 there was no incorporation of the programmatic changes. He is correct in that regard. That is why we have gone to this method of weighting the PLP loans, which is the programmatic change that he is referring to, it is different than the way we weigh the non-PLP loans.

Chairman MANZULLO. So are you agreeing on the subsidy rate for what OMB wants to do for 2004?

Mr. WILKINSON. I do not have a clue what they are doing for 2004. There has been no——

Chairman MANZULLO. 2003, I am sorry.

Mr. WILKINSON. Am I agreeing to that subsidy rate? Absolutely not.

Chairman MANZULLO. Dr. Blanchard just said that before 2003 they did not take into consideration programmatic changes, but after that date they do take that into consideration.

Mr. WILKINSON. In my opinion the change they made for fiscal 2003 is simple window dressing.

It made a minor change but did not address——

Chairman MANZULLO. Yes, but he said that they take it into consideration in 2003. So there has been apparently a major change in the manner of the calculations. Would you disagree with that?

Mr. WILKINSON. I disagree. There has not been a major change.

Chairman MANZULLO. Dr. Blanchard, is there a document that has been generated that shows that those elements that Mr. Wilkinson says are the program changes? Is there a document that shows that those have been taken into consideration for 2003?

Mr. BLANCHARD. Yes, sir. That document is the President's budget.

Chairman MANZULLO. Okay.

Do you agree with that, Mr. Wilkinson?

Mr. WILKINSON. I will agree that they made some changes in 2003 as it was from 2002, but the changes are very minor.

Chairman MANZULLO. Can you show us that section from the budget? Does anybody have it handy there?

Mr. BLANCHARD. What we did, I do not have it handy, sir, but I can tell you that in fiscal year 2002 the subsidy rate was 1.07 percent. Our calculation in implementing this new method that weights the PLP loans differently from the non-PLP, reduced that subsidy rate to .88 percent. That is a one-fifth reduction in the subsidy rate, sir. That is about a 19 basis point reduction in the subsidy rate. That is how significant this model reduced that subsidy rate.

Chairman MANZULLO. Do you agree that it is a reduction, Mr. Wilkinson?

Mr. WILKINSON. First of all, the 1.07 was too high. A 19 basis point shift when there has been $1.4 billion——

Chairman MANZULLO. He is saying it is going in the right direction.

Mr. WILKINSON. It has been going in the right direction for a decade. Very slowly. And we know that if they start the year with a 12.73 percent default rate we are going to have a downward re- estimate at the end of the year. WE are going to have one this year.

Chairman MANZULLO. So you are saying that even though it is a reduction, that the reduction still is not——

Mr. WILKINSON. WE would have to have——

Chairman MANZULLO [continuing]. Default range.

Mr. WILKINSON [continuing] A major downward turn in the performance of 7(a) loans to come close to the default estimate in the model. That to me is the real issue.

Chairman MANZULLO. Would you agree with that, Dr. Blanchard? This is sort of interesting, going back and forth here, but——

Mr. BLANCHARD. A hyperbole of that statement I can accept, but history has shown that we will not have another year like all of the extraordinary years that we had in the late 1990s.

Chairman MANZULLO. Okay.

Ms. VELAZQUEZ. And even with all those extraordinary years that you had in the late 1990s you did not do the right thing in terms of fixing the subsidy rate.

So Mr. Barreto, I believe we need to get one thing straight, and that is the notion which the Administration keeps saying that somehow this mess we are in is due to congressional actions aimed at giving small businesses some relief from being overcharged by program fees.

So that we are clear, it is our job, Congress' job, to legislate.

Based on the past record of the programs that participants were being grossly overcharged, we legislated a program change.

It is the Administration's job to implement that change. So you knew what the subsidy rate will be and you choose to fund the program at half this level.

So if you are looking to place the blame somewhere, look no further than the table where you and Ms. Dorn sit, because it lies right there.

So my question to you is, you have this legislated change for three months before the budget was released. Why do you choose not to go back and fix it?

Mr. BARRETO. Thank you, Mrs. Velazquez for the question. I appreciate it.

At no time are we trying to affix blame or point the finger. I think one of the things we are trying to do is clarify.

There is this misperception out there that the President and the Administration chose to cut the 7(a) program in half and as we——

Ms. VELAZQUEZ. But that is exactly what you did.

Mr. BARRETO. But as we indicated before, with the subsidy rate going down to the .88, which we were very happy about being able to get down to .88, with the current President's budget, that would have been able to provide for a $9.7 billion——

Ms. VELAZQUEZ. Excuse me. We changed the fee. You did not. We did it.

Mr. BARRETO. Yes.

Ms. VELAZQUEZ. And then you chose.

Mr. BARRETO. The budget had been completed before the time this legislation actually went into effect. But again, what we are trying to do is clarify the record to reflect that our intention was to have $9.7 billion available for 7(a) lending.

Ms. VELAZQUEZ. Mr. Barreto, you could spend the whole morning here giving me a nice explanation but you do not answer my question.

My question is why you, if you had three months to fix the subsidy rate, you did not.

Ms. Dorn, why did you not?

Ms. DORN. I think the point that we would make is three are sort of three components to this. One is the establishment of the subsidy rate which is based on criteria. There has been some discussion about the kind of criteria that goes into the calculation. You look at the history of the program, you look at the actual loans that have been defaulted on, and you, as was pointed out, we have actually taken into account the fact that the preferred lenders' default rate has been less. That was cranked into the formulation.

So for over a year we established a subsidy rate, and that is a separate exercise from either the establishment of the fee, which you point out Congress changed last year. And then the issue of the appropriation that we put against the program.

Ms. VELAZQUEZ. Let us move to the next question.

I am sure you have heard the accusations that OMB is using phony numbers to inflate the loan program subsidy rate. How do you respond to that?

Ms. DORN. Well Congresswoman, I understand the frustration that people feel when they see the history of this program, and I looked at the numbers of the loan subsidy rate and the re-estimates over the last years going back to fiscal year 1992 and I can say the program is not perfect.

You can see by looking at the re-estimates that over the last several years the margins are falling and they are falling rapidly.

For example in 1992 they missed it by $200 million. In fiscal year 2000 we missed it by $2 million. So there is some refinement going on in how we calculate the subsidy rate, and I appreciate the frustration that people fee.

I think we are making some progress.

Ms. VELAZQUEZ. Let me ask this question. Since the late 1990s SBA has engaged in the practice of selling defaulted 504 loans through asset sales. The track record for this has been a net recovery rate of approximately 50 percent. However in the Administration's recent budget you include in that recovery an assumption of just 20 percent. Where did the 30 percent go and how do you justify it?

Ms. DORN. I will have to turn to Hector for that.

Mr. BARRETO. On the asset sales that we do, it includes many——

Ms. VELAZQUEZ. Excuse me, Ms. Dorn. It was not SBA, it was OMB that established the 20 percent. The 30 percent. It is not SBA, it is OMB. Is not OMB the one saying it?

Ms. DORN. Well, OMB is indeed the place where the budget comes from, but we work very closely with——

Ms. VELAZQUEZ. Mr. Crawford, could you please tell me if this does not sound like a phony number to you?

Mr. CRAWFORD. Yes, ma'am. I would have to agree with you that the numbers are certainly strange.

If you look at the growth collection rate it is running downward from 67 to 58 percent. The expense rates are running nearly 40 percent. They are recovering a net of 20 percent.

If you look at the asset sales, there have been five asset sales to my understanding. They have sold a total of about 1300 loans that have gone bad. In our entire program since 1986 they sold nearly 900 notes related to those 1300 loans and their own numbers are a net recovery of 50 percent.

So I do not understand how you get from 50 percent to 20 percent. What happened to the other 30 percent?

Ms. VELAZQUEZ. Ms. Dorn, if we were to assume a 50 percent recovery rate, maybe he would be able to answer this question when she finishes.

If we were to assume a 50 percent recovery rate that has been the historical trend, what would the subsidy rate be?

Ms. DORN. I am sorry, Congresswoman, I do not know the answer to that question.

Ms. VELAZQUEZ. Do you have the answer to that question?

Mr. BARRETO. What I would like to do is give Dr. Blanchard another opportunity to explain that. It is a very important question in front of us right now about how that is determined and what happened to that other 30 percent as you mentioned.

Mr. BLANCHARD. Ms. Velazquez, Mr. Crawford's point about asset sales, and incorporating our 50 percent return on asset sales into recovery for the 504 program, we are comparing apples to oranges.

He is talking about the recovery for one loan program. The asset sales program engages in sales of products or assets from many of our loan programs. So that 50 percent recovery rate is a combined recovery rate from multiple loans of which 504 loans, defaulted 504 loans are only a small percentage.

Ms. VELAZQUEZ. Can you tell me what the rate would be if you have a recall rate of 50 percent?

Mr. BLANCHARD. No, I cannot tell you that right off the——

Ms. VELAZQUEZ. Mr. Crawford.

Mr. CRAWFORD. It looks to me like it would probably go, it would probably cut the borrower fee by probably close to 60 percent which would lead to a borrower fee probably in the .25 down from .42. So it would be a pretty substantial cut in the actual fee.

I would like to make a statement regarding Lloyd's comments about the asset sales.

It is my understanding that each of the asset sales consisted of a significant number of pools, each of which had homogeneous assets in those pools. In other words they did not want to sell short term notes and long term notes because Wall Street is not going to pay a lot of money for that kind of a pool.

Wall Street is going to look for a pool of loans or notes or collateral that is fairly consistent, and it is my understanding that our real estate notes as well as the real estate notes of 7(a) were put into similar pools and a fairly discreet number of pools.

Now the number that I use, the 50 percent, I was told by an SBA manager that that was in fact the recovery rate, the net recovery rate for 504 specifically, not for 7(a), not for disaster loans but 504.

Ms. VELAZQUEZ. Thank you.

Ms. Dorn, last year when Mr. Blanchard testified before the Senate, he stated that once the President's budget proposal is submitted to Congress the assumptions contained in the budget cannot be changed for subsidy rate purposes. Is that your position as well?

Ms. DORN. Congresswoman, the Federal Credit Reform Act specifically directs that that is the case.

Ms. VELAZQUEZ. What is the 7(a) default rate assumption used in determining the program fiscal year 2003 subsidy rate?

Ms. DORN. Congresswoman, as I think we previously testified, we used the subsidy rate of .88 for the 2003 budget.

Ms. VELAZQUEZ. It wasn't 12.73?

Mr. BARRETO. For the default rate?

Ms. VELAZQUEZ. The default rate.

What is the subsidy rate?

Ms. DORN. The subsidy rate is .88. I'm sorry, Congresswoman.

Ms. VELAZQUEZ. So the default rate for the——

Ms. DORN. I am sorry, I have been corrected. The subsidy rate is 1.76 in 2003 I am told.

Ms. VELAZQUEZ. So the default rate is 12.73. Is that correct?

Ms. DORN. That is correct.

Ms. VELAZQUEZ. That is why I am so puzzled. Because when you look at the default rate assumption for the 7(a) program containing Table Six of the credit supplement to the President's fiscal year 2003 budget it is a default rate of 9.38.

So which is it? 12.73 or 9.38?

Mr. BARRETO. Congresswoman, what I have just been told is that there was a typo in——

Ms. VELAZQUEZ. Oh, a typo.

Mr. BARRETO. There was a typo in that budget.

Ms. VELAZQUEZ. So what is it?

Mr. BARRETO. It is 12.73.

Mr. WILKINSON. I would direct your attention to the chart on the wall that says 8.19.

Chairman MANZULLO. I have 9.38 on the budget.

Ms. VELAZQUEZ. Tony, would you please explain this type of phony number here?

Mr. WILKINSON. It is real interesting. The credit supplement does contain the 9.38 default assumption which we would believe would be in the correct range of default that this program has been managed to. But it has on occasion been very difficult to get a straight answer on some of the information.

Again you look at a 9.38 in the credit supplement. They have a chart up here that says 8.19. The default estimate in the subsidy models show the 12.73.

Ms. VELAZQUEZ. Ms. Dorn, let us see if we find some more typos.

Let us look at Table Six of the credit supplement. If you look at the default rate assumptions for 504 it is 8.32 percent. Is that correct?

Ms. DORN. I do not have that table in front of me.

Mr. BARRETO. That is a correct number.

Ms. DORN. 8.32 is correct according to the Administrator.

Ms. VELAZQUEZ. So we do not have a typo there.

Ms. DORN. No.

Ms. VELAZQUEZ. Okay, good.

But if you look at page 49 of SBA's budget request you state for the 504 program, and quote, "Default amounts to about $60 to $70 million annually." With 504 loan volume averaging approximately $2 billion for the last several years this $60 to $70 million in annual defaults would equate to a default rate of approximately three to four percent, not 8.32 percent.

That cannot be right.

Ms. Dorn, how does OMB get 8.3 percent for a default forecast given the $60 to $70 million forecast in the budget?

Ms. DORN. Congresswoman, I would refer back to Dr. Blanchard's testimony about how these loans are calculated using historical data and historical default rates.

Ms. VELAZQUEZ. Mr. Crawford, maybe you will be able to explain that.

Mr. CRAWFORD. Yes, ma'am.

I do not have a fancy chart like that because I cannot afford it, but I have a little chart that I put in the back of my testimony that has the real historical default rates for our program. These numbers are not projections. They are taken from our trustee, the Bank of New York, so they are real, honest to goodness numbers.

I decided to plot a little curve against those default rates, and that is that heavy black line. It seems to indicate that the default rate for the last 12 years has been running anywhere from three, 3.5, four, 4.5 percent.

Ms. VELAZQUEZ. Not eight percent.

Mr. CRAWFORD. Not 8.3 percent. So I have no explanation for where 8.3 comes from.

Chairman MANZULLO. Can I go to Ms. Napolitano before we——

Ms. VELAZQUEZ. Let me, just one more question.

Chairman MANZULLO. Okay.

Ms. VELAZQUEZ. Ms. Dorn, I guess Mr. Crawford that these again sound like phony numbers.

But Ms. Dorn, you stated earlier that OMB was not using phony numbers, but how can you say that when you are using incorrect recovery, incorrect loss levels, and incorrect defaults?

The last company that kept their books like this was a little company in Texas, Enron. And you know what happened to them.

So how can you sit before this Committee and tell us this garbage with a straight face? Because it does not matter what model you use. If you put garbage in you will get garbage out, and that is what we have seen here today.

Thank you, Mr. Chairman.

Chairman MANZULLO. I would like to go to Ms. Napolitano.

Somewhere during the course of this I would like to know if the SBA ever advised this Committee that there was a typo error in this budget. Was that ever done?

Mr. BLANCHARD. I am embarrassed to say, Mr. Chairman, that I just realized it today.

Ms. VELAZQUEZ. Really?

Chairman MANZULLO. Okay.

Ms. Napolitano?

Ms. NAPOLITANO. Thank you, Mr. Chair. I am enjoying the questioning that our Ranking Member is doing. I hate to interrupt her as she is on a roll.

But I would like to ask one of the questions that has kind of puzzled me, and this is Ms. Dorn's testimony, on her page, probably about page four in the OMB's ruling implementing FCRA. And I direct you to paragraph two. The second sentence starts off, 'Staff worked to ensure the estimates have been calculated in accordance with the requirements of FCRA and applicable guidance issued by OMB, Treasury, Financial Accounting Standards Advisory Board and other entities. A large part of its role is ensuring that consistent standards are applied to similar programs,' and it goes on.

How do you use the same standards for the SBIC program as you do for the 7(a) and/or the 504? Is that correct? Do you use the same standards?

Ms. DORN. We use similar inputs, Congresswoman.

I think one of the issues here is how we have gotten to the subsidy rate. We had a long discussion about that. One of the issues that we talked about is the historical performance of loans and the historical performance of defaults.

Ms. NAPOLITANO. That is not the information we are getting, is that you do not use the same standards.

Ms. DORN. Well clearly there are some differences between SBIC and——

Ms. NAPOLITANO. What differences are there? In other words, what is it that separates one from the other and why are not the same standards applied to both? SBIC is what we are getting to, the small business investment program.

Ms. DORN. Congresswoman, I think we have tailored some criteria to deal with the different kinds of—Clearly 7(a) is a different kind of program than 504 which is a little different than the program that you cite.

I think in general we try to use historical data. We have tried to pump in more current, changes in current law, changes in current econometrics——

Ms. NAPOLITANO. You are not using the same standards?

Tony, can you explain this?

Mr. WILKINSON. I do not think they do consistently apply the standards to similar programs. We are active in with the B&I program over in Department of Ag, it gets a little different treatment.

I am most concerned about the statement that they calculate the rates in accordance with the requirements of the Federal Credit Reform Act. There are no requirements in the Federal Credit Reform Act of how they calculate the subsidy rate.

Ms. Dorn says they were required to use all historical cash flows. Nowhere in the Federal Credit Reform Act does it say they have to use all historical cash flows. Again, we go back to the Senate Roundtable where six or seven different types of approaches that would have been more reflective of the performance of the program were presented and all of them were rejected, and yet OMB decided to keep the one that gave the highest default estimates. Even though they know it is not in a reasonable range.

Ms. NAPOLITANO. Mr. Wilkinson, Tony, would you comment more about the Ag? You mentioned it and you just skimmed over it. That is important.

Mr. WILKINSON. We have been working on the Business and Industry loan program and have not has as much luck in learning all about their subsidy model as we have in the 7(a) program, so I will not profess to be an expert on their model and should save that one for another day.

Ms. NAPOLITANO. Okay.

Then Ms. Dorn, given that there is apparently a discrepancy in how people are looking at how you apply the standards, are you willing to correct this inequity?

Ms. DORN. Congresswoman, we are working hard on trying to refine the data to go into the econometric model, but——

Ms. NAPOLITANO. It is not the refining of the data I am concerned with. It is the application of the data that concerns me.

Ms. DORN. We do this on an annual basis, so clearly every year we review what we have done in the past and we are trying to refine the data which, as I pointed out before you came in, has resulted in a significant improvement on our estimates. In the early 1990s we were overestimating in the $200 million range; in fiscal 2000 we missed it by $2 million.

So there is improvement in this data. It is not a perfect science, and we welcome your input and the Committee's input into the different factors that need to be considered. This is not a static calculation that does not change from year to year. We have continued to try and refine the model.

Ms. NAPOLITANO. I must say that I have a lot of small business and Mr. Barreto knows that, who really count on these loan programs, and I am finding out that a lot of them are not qualifying simply because of the different standards utilized.

So Mr. Chair, I yield back the balance of my time to Ms. Velazquez if Ms. Velazquez wants to finish up.

Chairman MANZULLO. Let me go to Mr. Issa.

Ms. VELAZQUEZ. Okay.

Mr. ISSA. Thank you, Mr. Chairman.

I apologize for not being here for the whole time. Unfortunately I have an amendment on the Floor which is the usual excuse for rudeness we have here in this body.

But I am very concerned about this and I guess directing to the left side of the panel, especially to the Administrator and Ms. Dorn, I came out of the business world. I was both a CEO and on many boards. What I hear you saying, and for that matter said very eloquently in writing, is that there is a historic difference between what you say is going to happen and what happens.

In business we talk about a quarter—maybe, being an anomaly. Two quarters is a trend. Three quarters is a question of whether the CEO is still going to be around.

Now maybe we act too quickly in business, but a decade seems to be too slow even for government.

What I am sharing the sentiments of my colleagues is, why is it that this year, not next year, not the year after, can we not have a substantial, based on historic, and you certainly have the evidence, the data now to do it, why can we not have a halving of the difference? Why is it that while you are calculating we cannot narrow this from eight to seven? Maybe not to four? Maybe not to what we would like to believe the past performance shows for the future. But what is it, if there is nothing in the body of law that we have delivered you that stops you, what stops you from doing what you can to improve your ability to deliver services? And clearly, based on what I have seen, you have the ability to do it. This is a decision you are making.

When a CEO makes a decision to continue miscalculating something historically, I have to ask how long do I want to have people who miscalculate that way?

I will take either of your answers.

Ms. DORN. Well Congressman, we do not intentionally miscalculate. I think there is a process of refining that we have made some significant progress in the last couple of years. I cannot speak very well to the program over the last ten years in terms of how the program was run, but I think we are making a significant effort to try and narrow the differences here.

The other thing that I would point out is something that you as a businessman know very well, and that is that the period of time between 1992 and 2000 was a period of extraordinary growth and economic prosperity in this country. We have seen over the last year that that is not necessarily the template for every year for the rest of all time. We have to take that into account.

There have been experiences where the federal government has provided loans in response to outside influences and other things that turned out not to be a great idea. The S&L situation of the early 1990s is a great example of where the government overextended itself.

Mr. ISSA. And I am not asking you to change your model for who you loan to. I am not saying we should change the risk calculation.

What I am saying is you have a past performance, a success if you will, of having a given default rate and a given cost for it, and yet we are asked here, with the reluctance of the appropriators, to over-appropriate if you will based on a historic misjudgment.

I do not agree with you that you have made substantial reforms because if the facts continue to show this big a disparity, this is like a four percent loss at the bottom line in your corporation every year, and I am not even giving you credit for the multiplier effect to the benefit of your making greater amounts of loans, being able to do more. Forget about all of that. Forget about what the multiplier is.

The bottom line is you are miscalculating by an amount greater than we tolerate losses in business for a quarter or two and you have done it and your predecessors have done it for a decade.

My question succinctly back to you is, why is it that you cannot make a substantive change this year to reduce that disparity? You do understand that this body, and we are the people, at least are part of the body that appropriates if necessary.

If we suddenly see a change it is not a huge amount of dollars, it is not something that Congress is not going to go okay, for one year we can do a supplemental to make up for some anomaly. The fact is, you are not exercising, as I see it, the power you have by every year miscalculating by this huge amount and then coming back and saying effectively look how well we did. I do not want you to do that well. I want you to be accurate, or at least much closer.

Chairman MANZULLO. Okay.

Mr. WILKINSON. Can I add on just one statement?

Mr. ISSA. Please.

Mr. WILKINSON. That is based on the default assumptions that are plugged into the model we are going to have to go ask for appropriation dollars for fiscal 2003 in an amount double what we are going to need. And it is exactly right, this makes the appropriation process very, very inefficient.

Chairman MANZULLO. Before I go on to Congresswoman Millender-McDonald, let me ask a question, Dr. Blanchard.

The typo that appears on page 20 of the budget on Table Six at 9.38, you said that is a typographical error. It should be the 8.1 figure, Doctor?

Mr. BLANCHARD. Mr. Chairman, this is a number that I just saw this morning before we sat down in front of this committee.

Chairman MANZULLO. You mean the 9.3?

Mr. BLANCHARD. That is right. That number should be 12.73, sir.

Chairman MANZULLO. It should be 12.73?

Mr. BLANCHARD. That is correct.

Chairman MANZULLO. But it is 8.1 on the chart.

Ms. VELAZQUEZ. Mr. Chairman?

Chairman MANZULLO. Just a second.

Mr. BLANCHARD. That number should be 12.73 which is the default rate that SBA has projected for fiscal year 2003.

Chairman MANZULLO. But that is 8.195 up there.

Mr. BLANCHARD. The 8.19 is equivalent to the 12.73 and let me explain how.

You are dividing the default in this chart by total loan volume. But as you know, SBA only guarantees 85 percent of that total loan volume.

In the budget, the way we produce that number in our 12 percent assumption is defaults divided by the proportion of the outstanding loans that SBA guarantees.

In a sense, sir, the denominator is smaller driving that number up. They are equivalent to each other.

Chairman MANZULLO. So where it says 9.38 it should be 12 point——

Mr. BLANCHARD. Seven-three.

Chairman MANZULLO. The fact that there is a typographical error that is in this table on Table Six on page 20, does that have anything to do with the final calculation of the subsidy rate?

Mr. BLANCHARD. No, sir. It does not.

Chairman MANZULLO. Okay.

Ms. Millender-McDonald?

Ms. MILLENDER-MCDONALD. Thank you, Mr. Chairman, and than, you and the Ranking Member for providing us this opportunity to speak about a very critical issue.

Again, I think the basic question that has been raised here is whether or not OMB should rely on ten years of data versus more recent data to produce a default rate that appropriate current reality?

I am sorry that I was not here, but I need to kind of get that back in front of me, why is it that we are relying on ten years of data as opposed to something that is more current?

Perhaps you have answered that, but I need to hear it again.

Ms. DORN. No, I am happy to explain our rationale on that front.

Our rationale is simply that for this program and for the other federal loan programs we rely on the historical data that we have. In this case it goes back I think to 1986 because economic conditions do play heavily into historical defaults and credits issued. So we do use the data that we have going back but it is not the only data that we have plugged into the calculation. And as we have gone forward we have sought to refine that.

As we pointed out in the fiscal 2003 calculation we did use the information that default rates are lower for those loans that go through preferred lenders and we did crank that into the data which did reduce the subsidy rate fairly significantly, by about 40 percent?

Mr. BARRETO. Twenty percent.

Ms. DORN. Twenty percent for fiscal year 2003.

So we are continuing to work to make it more reflective of not only the historical past but the more recent changes in law and performance.

Ms. MILLENDER-MCDONALD. Then how many 7(a) loans that have been made since 1986 are still on the books of the SBA and what percentage of these loans represent the loans made in those years and of the loans outstanding today?

Ms. DORN. Can I turn that to SBA? They have a better——

Mr. BARRETO. We have to provide you with an accurate count on that, Congresswoman, in terms of how many loans are still in the portfolio. We would be happy to do that. We did not bring that specific number with us today but we can get it to you very quickly.

Ms. MILLENDER-MCDONALD. How soon can we expect that, Mr. Administrator?

Mr. BARRETO. I think we should have it to you in the next 48 hours.

Ms. MILLENDER-MCDONALD. That would be great because I really do need to review that. This question is for either Mr. Wilkinson or Mr. Crawford.

Do you have any confidence small businesses and your members are going to get a better shake from this econometric model than they do from the present model?

Mr. WILKINSON. I said in my verbal testimony that——

Ms. MILLENDER-MCDONALD. And I am sorry, I had three other Committees——

Mr. WILKINSON. That's fine.

We are concerned about a new model. The model that we have today is really fairly simple to understand. We have issues with some of the assumptions that are plugged into the model. The econometric model is going to use many more 'relevant factors' all of which are going to have a weighting that's going to be determined by somebody at OMB and we likened it to the fact that we have broken open the old black box——

Ms. MILLENDER-MCDONALD. Is that to your benefit or what?

Mr. WILKINSON. I doubt it.

Ms. MILLENDER-MCDONALD. I see the gentleman in the blue shirt shaking his head in an adverse way. Dr. Blanchard.

Dr. Blanchard, why are you disagreeing with Mr. Wilkinson?

Mr. BLANCHARD. I do agree with Mr. Wilkinson that the econometric model will in effect weight multiple factors in accordance with their impact on the subsidy rates. However, those weights are not set arbitrarily by OMB or SBA. Those weights are determined by the data itself. The historical data itself.

Mr. BARRETO. Can I also take a stab at it?

Ms. MILLENDER-MCDONALD. Yes.

Mr. BARRETO. We——

Chairman MANZULLO. What does that mean?

Mr. BARRETO. What I would like to comment on is that the econometric model is not going to determine the subsidy rate, but one of the things the Congresswoman said is that we have to be very careful of what we are putting in.

We believe the econometric model is going to allow us to come up with more accurate measurements so that what we are putting in provides us a much more realistic idea of what is actually occurring.

We did that this last year, and I also want to say that we realized that this was a big issue before we came on board. I got on board in August and we began working on this situation immediately.

It is difficult for us to be able to look back and say all the factors that people were considering at the time they were developing subsidy rates in the past. But what we do understand and what we are very clear on is that we need to do a better job, that we need to be more accurate.

That is why we felt very gratified that we were able to take the subsidy rate from 1.07 down to .88. In a very short period of time we were able to make some progress. We are going in the right direction.

Obviously the fees went down because of P.L. 107–100, that caused the subsidy rate to go back up. But that was never our intention. That was never something that we had anticipated.

If that subsidy rate would have been held at that .88, we would be looking at a budget authority right now of $9.7 billion for our 7(a) loan program. That was our intention.

We will continue to work with you, we will continue to work with the organizations that are here because the work is not done. We think that the econometric model is going to get us to a place where we are going to have more accurate reflections and we are not going to have this continued problem because we are concerned about it as well.

We have to be competitive. We have to think and act like a small business just as the Congressman said. If our loans become too expensive, we are going to cease to have the ability to do what our mission is, which is to touch more small businesses.

At the end of the day we want to do more small business loans. WE think that our average loan size right now is too large. Inc. Magazine says that most small businesses are financed with $50,000. Our average loan size is $239,000.

Ms. MILLENDER-MCDONALD. Mr. Administrator, I want to yield to the Ranking Member——

Chairman MANZULLO. Ms. Millender-McDonald, the time has expired. Let us let Mrs. Kelly——

Ms. MILLENDER-MCDONALD. Oh, my time has expired? I just wanted to answer the—I wanted to convey——

Chairman MANZULLO. Let me get a question in because the bell is going to go off and I want to make sure everybody has the opportunity to ask questions.

Mrs. Kelly?

Ms. KELLY. Thank you very much.

Actually, there are two things.

Mr. Barreto, I know you have not been at the SBA for a very long period of time, but I have been sitting here year after year after year listening to the SBA come in and say we want to do a better job, and yet I know there are people in my area who have come in and asked for 7(a) loans and they are told we do not want to process those loans, they are too small. They want to process loans that are larger because they have to do the same amount of paperwork.

We need some real change. We need some people who are dedicated to coming here in front of this Small Business Committee and saying we have changed it. We have reduced the paperwork and we are responsive to the smaller loan needs of these people who are trying to get into the program.

We cannot grow small business in this nation unless you address these problems.

I really hope that this coming fall, perhaps, you will come back to this Committee and you will come back and say here is what we have actually done, and you will have done something.

The small businesses of this nation I do not think can any longer wait.

I want to go also to Mr. Wilkinson.

Mr. Wilkinson, I think you had a response to Ms. Millender-McDonald's question. I would like to give you time to respond.

Mr. WILKINSON. Yes, I did have one more comment.

At our annual convention last fall in San Francisco our lobbyist stood up and made a statement that he believed that OMB created assumptions so that it would force an answer in the model that was going to achieve a desired result. That they knew what they wanted the answer to be so they would plug in assumptions to match it. This was his speech from the statement.

Two former OMB budget examiners came up after his speech and said you are exactly correct.

Exactly correct.

Hence why we are a little excited about getting this problem fixed, and why we would have no more confidence in an econometric model that has even more assumptions that are going to be plugged into the model.

I hope things work out, but hence our concern.

Thank you for allowing me to respond.

Ms. KELLY. Thank you, Mr. Chairman. I yield back.

Chairman MANZULLO. I have a question here.

Two weeks ago we had a hearing with the OMB and the Administrator on why six months had passed and the size standards had not been changed. What is apparent at this point is that OMB may be doing its job too well. Their job is to sit there and to make sure that as little money is spent as possible as they sit there at the throttle of how the Administration wants to spend money.

But it reaches a point where I think what OMB is doing is not correct because it is so conservative in the estimates that it is actually doing a disservice to small business people.

What we are going to do is sit down and we are going to examine the OMB and how they go about this because I think the starting point of OMB is to say we are going to take the most conservative position possible. But in all fairness, if you take a look at what happened in 1996, OMB underestimated the loss by $257 million so they were short almost a quarter of a million dollars and that will cause anybody to be very conservative coming out of the box for the next anticipated years.

The next year, for 1997 they were long by $16 million; for 1998 by $279 million; 1999 by $545 million; 2000 by $235 million; 2001 by $528 million; 2002 by $183 million.

I think what is happening is that OMB is still reacting to what was an incorrect estimate for the loss during 1996.

There were more questions that people wanted to ask. However you want to divide it, that is okay with me.

Ms. NAPOLITANO. I want to defer to the Ranking Member.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Ms. Dorn, is not the outcome of econometric modeling dependent upon the assumptions used in the model, just as the present model's results depend on the assumptions used in it?

Ms. DORN. Yes, maam. We are——

Ms. VELAZQUEZ. I just want a yes or no.

Is it a fact, Mr. Barreto you made reference to it, that you are moving to an econometric model, an admission that the current system is broken?

Ms. DORN. I think we believe an econometric model would provide more accurate data.

Ms. VELAZQUEZ. So you believe that the present system is broken is it not? Do you not?

Ms. DORN. Congresswoman, I would——

Ms. VELAZQUEZ. Just say yes or no.

Ms. DORN. I would prefer to use my own words, which is that this is a process of refinement. I would agree with you that the system is not close to perfect. We are making some changes in it even as we speak that are going to make it more accurate.

Ms. VELAZQUEZ. Mr. Wilkinson?

Mr. WILKINSON. Can I go back to the Chairman's comment? You were reading from some sheet that talked about expected default rates. From the numbers I have in the budget they showed an expected default rate in 1996 of 17.26 and the expected default rate of 9.97. They more than doubled the estimate in 1996. The estimate in 1997 was 17.25, they were on pace to do 9.13. I am not following——

Chairman MANZULLO. This is the actual amount of loss or overcharge. In 1996 OMB underestimated the loss by $257 million. Then in subsequent years they overestimated.

I just brought that up to show that the numbers that they are working with, the reason they are perhaps so conservative is because they had in 1995, they underestimated the loss by a quarter of a billion dollars.

Mr. WILKINSON. In 1996——

Chairman MANZULLO. 1996 rather.

Mr. WILKINSON. In 1996 there was a downward re-estimate of about $100 million.

Chairman MANZULLO. These are the re-estimates on it from OMB.

Mr. WILKINSON. I guess I would point you to page one of my testimony that lists the re-estimates that have been reflected in the annual budgets coming forward.

Chairman MANZULLO. I am on page 205 of the budget.

If somebody else has another question here, please go ahead.

Ms. VELAZQUEZ. I have a question, Mr. Chairman.

Ms. Dorn, how is the calculation of the assumptions for the econometric model going to correct the existing inaccuracies of today's method of forecasting defaults, prepayments and recoveries?

Ms. DORN. Congresswoman, we are looking to incorporate not only the historical data which we have used and will continue to use, but also to factor in more current conditions.

Lloyd, do you want to talk about that in any more detail?

Mr. BLANCHARD. Sure.

Ms. DORN. SBA is the agency that does this. OMB has responsibilities under the Federal Credit Reform Act, but OMB does not, contrary to popular belief, just make up these numbers.

Mr. BLANCHARD. Ms. Dorn is correct, Ms. Velazquez. The econometric model is simply an estimation tool. It estimates the default rate.

The assumptions that underlie the econometric model are technical assumptions. They are not the assumptions that Mr. Wilkinson refers to. That model itself helps us, it takes business factors, program factors, economic factors and says how do these factors predict performance of these loans? Performance is the same thing as the default rate. Then that default rate is plugged into the cash flow model to predict a subsidy rate.

Ms. VELAZQUEZ. Who is going to decide the assumptions used? OMB? SBA?

Mr. BLANCHARD. The assumptions used, ma'am, are, those that come from data. Those come from what the unemployment rate is, for instance. What the President's budget publishes as the unemployment rate. If that is a relevant factor, which I believe we all think it is.

Ms. VELAZQUEZ. Mr. Barreto, you mentioned that you are going to use OFHEO to implement the model. I have serious concerns about OFHEO because home loans fit very exact criteria and perform in very predictable manners. All loans are underwritten using maximum guidelines that are established for total installment of debt including new home loans versus gross monthly income as a percentage. How statements of gross monthly income as a percentage will not amount to a price value.

So due to the very precise underwriting criteria that is followed by every lender granting home loans, they perform in a very predictable fashion and are easily securitized.

It is also very easy to predict loss due to the very large volumes of loans that are guaranteed on a regular basis, making subsidy rate models very simple to implement.

These loans all fit in the round hole or square hole, depending on the market they are serving.

Business loan underwriting is not done using that criteria but lenders apply different standards as it relates to cash flow coverage, debt to wealth and so forth. Therefore these loans do not fit square holes and/or round holes. This makes it much more difficult to predict how these loans will behave or perform over their life.

At liquidation time, values of equipment will vary greatly due to present economy and the health or sickness of a certain type of business.

Based on that, how can an oversight agency who's primary function is to oversee a very predictable industry now adapt a similar model to an industry that has no hard and fast underwriting guidelines?

Mr. BARRETO. Great question. Thank you, Congresswoman.

We chose OFHEO for a couple of different reasons. First of all as we stated earlier, GAO and OMB when we were talking about what an effective approach would be, believed that the econometric modeling approach would help us in the short term and would definitely help us in the long term.

One of the reasons that we chose OFHEO is because they have a lot of expertise in statistical analysis and working with econometric models. I agree with you though, and that is that you cannot take another industry that is dissimilar and try to overlay a system that works there over here. We are very mindful of that. Yet they do have the oversight responsibility for Fannie Mae and Freddie Mac, but also we were very intrigued by the fact that they hired Dr. Robert Dunsky.

Dr. Robert Dunsky was formerly with PriceWaterhouseCoopers and he is very very familiar with the SBA asset sales program, and with our loan programs. We are very excited about is his understanding of the agency, his expertise, the fact that he has this expertise coming from the private sector. And I believe that working together with him, since he is already familiar with us, we are going to be able to come up with a system that is customized to the SBA.

At the end of the day, a lot of larger agencies are able to do this. They have teams of economists that work for them, et cetera, but we needed to find a solution that was definitely going to be cost-effective and definitely be efficient.

We think that OFHEO offers——

Ms. VELAZQUEZ. Mr. Barreto, do you know why you do not, Congress allow Freddie Mac and Fannie Mae do business loans? This is like compare day and night. And we sit on the Financial Services Committee. We know the competence of OFHEO in dealing with Freddie Mac and Fannie Mae.

Mr. BARRETO. OFHEO is not going to be doing our lending program but they will be helping us to develop an econometric model.

Chairman MANZULLO. Why do we not have these two gentlemen help you develop the econometric model?

Mr. BARRETO. We share a lot of information already and we are always open to getting more information and helping.

I know when we worked with NADCO in the past, we actually developed a pilot program with them, provided them with a lot of our information because we know that NADCO has said to us in the past," we think there is a better way of doing this."

We are currently working with them and we are hopeful to receive some of that feedback from the discussions that we had on ways that we can do it better.

Chairman MANZULLO. We have to wind this up.

A very quick question.

Mr. ISSA. The question can be responded to in writing, if you don't mind. Both from OMB and SBA if possible.

Making an assumption that you have a time horizon that of at least five years for your reserves, not using a single year, not loading in the up or the down market, but using at least five years. If you were taking, if you will, the budget and multiplying it times five, would you arrive at a different number? If so, what would that reserve number be?

Now you can use ten years, I don't mind, because I personally believe that if you look at any horizon five years or longer what you are going to say is our problem is a one year calculation.

Because we are looking at ten years, but then we are always loading in a higher number for one year because of the things that might happen.

If you come back to us with a five year or greater, and I prefer at least five, but you can do give or ten, and give us the number you believe if you plugged it in without all those hypotheticals for any one year, but knowing that over the years those hypotheticals fade, and give us that number, it may empower this Committee to recommend to the full Congress some additional discretion for you to make these calculations to narrow what we perceive as an unwarranted delta between reality and predictions.

Thank you.

Mr. WILKINSON. Congressman, attached to my testimony is a GAO report that did a five year look-back——

Chairman MANZULLO. We are running out of time here. I want to thank everybody. This has been great.

Will Rogers talked about what the country needs is a one-armed economist because the economists will say on the one hand you get this, on the other hand you get the other. Everybody gets an A+ here for sincerity and honesty and workmanship and craftsmanship and everything. It is interesting because the problem here is that the members of the Small Business Committee are accusing the Administration of being too conservative in their estimates. You might want to think about that. But that is your job as a watchdog.

I look forward to working with you very closely. Mr. Barreto, as soon as he was confirmed came in my office and he said let's talk about this subsidy rate. OMB came in and the first thing out of the box was that this is very difficult, we want to work with you on it. And we look forward again to a very close working relationship because I know your heart is—

I would assure these two gentlemen over here that these men are very sincere and want to work on this and continue the dialogue because they are listening and I know I am.

Thank you, and good luck on that new baby.

Mr. BARRETO. Thank you very much, Mr. Chairman and Ranking Member Velazquez.

Chairman MANZULLO. Thank you.

[Whereupon, at 12:02 p.m. the Committee was adjourned.]

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

March 13, 2002

OPENING STATEMENT
CHAIRMAN DONALD A. MANZULLO
COMMITTEE ON SMALL BUSINESS

"Subsidy Rate Calculation: An Unfair Tax on Small Businesses?"

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.

We are here today to discuss the subsidy rate calculations for the 7(a) and 504 loan programs. Let me first commend the Administration for recognizing the importance of this issue and beginning to correct the problem. I have seen more movement on this issue over the past eight months than over the past eight years, thanks in large part to the personal involvement of Dr. Lloyd Blanchard who left OMB to join SBA as its Chief Operating Officer.

The subsidy rate calculation has changed to weigh loans originated by the Preferred Lenders Program (PLP) more heavily than other SBA loans, which dropped the subsidy rate by 20 percent. I appreciate that change. The Administration has also committed to developing an econometric model for the next budget cycle, which it is hoped will provide a more accurate forecast of the performance of the SBA loan portfolios.

I also appreciate the willingness of the SBA to examine other alternatives to make sure that access to the 7(a) program is not cut in half next year. I look forward to working with the SBA as a constructive partner to see what we can do together.

I wish we had an accurate subsidy rate calculation now so that there would be no question about the availability of the 7(a) program in 2003. Fees could also be reduced in the 504 program. Inaccurate subsidy costs result in overpayment of fees and eliminates flexibility in program delivery. I trust that we will not be in this predicament next year.

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
by the
Honorable Nydia M. Velázquez
Small Business Committee Hearing on the Subsidy Rate
March 13, 2002

It should come as no surprise to anyone on this committee that access to capital is access to opportunity. It is the one tenet of business development that holds true regardless of the time, place or industry. If entrepreneurs can't tap into credit, the difficult task of starting a business can become insurmountable.

That is where the SBA loan programs come to the rescue. With competitive interest rates and a streamlined application process, these programs have been responsible for lending over $10 billion dollars annually --- providing 40 percent of the long-term capital needs for small business.

These lending programs bridge the gap between affordability and accessibility --- creating a partnership with the private sector that is the government's best bargain investment for its money.

Unfortunately, a disconnect in both Democratic and Republican Administrations has limited the reach of these programs, which have the potential to help many more small businesses.

This disconnect has translated into an over-charge for both lenders and borrowers of more than $1 billion dollars to date. This is a tax, plain and simple, and it is the most blunt example of the arrogance of our government that I have seen in my service in Congress.

Every year we raise this issue, yet all we hear are excuses. Either the model is not right or more data are needed --- but always an excuse, and never a solution. What has been clear is that the OMB in both Democratic and Republican administrations have been cooking the books in an attempt to hide this stealth tax on small businesses. And it taps our nation's entrepreneurs as a cash cow for the U.S. Treasury.

Frustration with this complacency and negligence forced a coalition of lawmakers, including me, to cut the fee for 7(a) lending in half in order to open up more capital and reduce the cost to small businesses.

This move presented the Administration with a golden opportunity to do the right thing and finally report an accurate subsidy rate.

Unfortunately, the Administration again chose to play budget games with this year's Budget proposal --- jacking up the subsidy rate for the 7a program to almost double the current level!

The Bush Administration's excuse for increasing what they should have lowered this time was our fee reduction. But if the fee reduction is their excuse, what possible explanation can there be for the 504 program --- which also saw its fee increase without any subsidy rate reduction? This is just one example of the inconsistency that has plagued this debate.

Another example is all the phony numbers that are floating around. In many cases the figures used to calculate the default rates so critical to the overall subsidy rate are laughable --- and are even contradicted by the Administration's own budget.

This junk math will taint almost any proposed solution. The latest excuse we will hear is that SBA has contracted OFHEO to help construct an "econometric model" to help more accurately predict true program performance. But given all the phony numbers floating around, no equation will ever accurately report the true cost of the program --- because if you put garbage in, you most certainly will get garbage out.

This is the reckoning time --- either OMB and SBA reports an accurate subsidy rate, or we on the Committee working with other like-minded members will do it ourselves --- even if it means taking the money from OMB and SBA to make up the shortfall --- or making changes to Credit Reform. Or even if we have to legislate the subsidy rate every year!

Yes --- these are drastic actions. But this problem has gone on for too long to be left unresolved any longer.

This change is especially critical at a time when our country is attempting to climb out of a recession. Small businesses make a crucial contribution to this effort --- they hauled us out of the last recession into the greatest peacetime expansion on record. They will do it again, with our help.

So the question for this committee and the administration is --- do we fix this problem and provide a $5 billion dollar stimulus to this nation's small businesses to go out and create jobs --- or do we continue the Draconian practice of taxing small businesses and keep them from providing the boost this economy so desperately needs?

I know which way I am leaning, Mr. Chairman, and I'm pretty sure about you, too.

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
March 13, 2002

CONTACT: Wendy Belzer,
James Snyder (202) 225-2361

Velázquez Calls on OMB to End Stealth Tax
Subsidy miscalculation leaves 7(a) Program Facing Deep Cuts

WASHINGTON – Congresswoman Nydia Velázquez (D-NY), Ranking Member of the Committee on Small Business, demanded that OMB fix the subsidy rate for SBA's most popular loan program – the 7(a). Subsidy rate miscalculations have cost small businesses an estimated $1 billion over the last decade.

"This is a tax on small business, plain and simple, and it is the most blunt example of the arrogance of our government that I have seen in my service in Congress," Velázquez said. "What has been clear is that OMB, in both the previous Democratic and Republic Administrations, has been cooking the books in an attempt to hide this stealth tax on small businesses. And it taps our nation's entrepreneurs as a cash cow for the U.S. Treasury."

Each year, the Committee has raised this issue, but no action to correct the problem has been taken. Due to this negligence, Congresswoman Velázquez and other lawmakers were forced to cut the fees for the 7(a) Program in half last year to open up more capital and reduce the cost of the program to small businesses.

This move presented the Administration with an opportunity to finally report an accurate subsidy rate, but instead they doubled it, causing lending in the 7(a) Program to drop by almost $5 billion. Congresswoman Velázquez announced that if OMB and SBA fail to report an accurate subsidy rate, Congress will take action to remedy the problem.

"This is reckoning time – either OMB and SBA report an accurate subsidy rate, or we on the Committee working with other like-minded members will do it ourselves," Velázquez said. "Even if it means taking the money from OMB and SBA to make up the shortfall – or making changes to Credit Reform. Or even if we have to legislate the subsidy rate each year."

An accurate subsidy rate calculation is especially critical now as the country attempts to pull itself out of a recession. Small businesses make the difference in this effort – they were able to haul the U.S. economy out of the last recession into the greatest peacetime expansion on record. SBA loan programs have been responsible for lending over $10 billion annually, providing 40% of the long-term capital needs for small business.

"Access to capital is access to opportunity," Velázquez said. "If entrepreneurs are unable to tap into credit, the difficult task of starting and expanding a business can become insurmountable."

###

2241 Rayburn HOB Washington, D.C. 20515 www.house.gov/smbiz/democrats

Testimony of Nancy Dorn
Before the House Small Business Committee
March 13, 2002

Chairman Manzullo, Congresswoman Velázquez, and members of the committee, I am Nancy Dorn, Deputy Director of the Office of Management and Budget (OMB). I am pleased to be here today to discuss OMB's role in implementing the Federal Credit Reform Act of 1990 (FCRA). It is in that capacity that OMB continually works with SBA on the cost estimations for its loan programs.

Before I begin, let me say that it is unfortunate that the premature release of preliminary and incomplete estimates for SBA's 7(a) business loan program may have led to unrealized expectations. I would like to point out that our efforts to improve the accuracy of the subsidy rate calculation, the first such effort in over a decade, resulted in a 20 percent reduction in cost. Administrator Barreto will explain in further detail the steps OMB and SBA took to improve the methodology and the progress made in developing an econometric model for use in the fiscal year 2004 Budget.

The FY 2003 Budget

While the Administration recognizes the importance of SBA's lending programs, we feel that the best way to address the needs of small business is through sound tax and regulatory policy. Reductions in individual taxes benefit the approximately 20 million small businesses who pay taxes at individual income rates. In addition, the Administration is committed to reducing the financial and administrative burden on small businesses of complying with tax, environmental, health and labor regulations, which again benefits the vast majority of the nation's 25 million small businesses.

To address the lending needs of small businesses affected by the September 11th attacks, the Congress passed and the President signed legislation that temporarily lowers fees for SBA lending programs and transfers more risk to the government. While the fee reductions may help those businesses and lenders that participate in SBA programs, it also means that the subsidy rate and cost of these programs rises. Given the additional cost, the budget supports a 7(a) loan volume that is lower than FY 2002 loan volume even with an increase in appropriations for the basic 7(a) program. With respect to the FY 2003 budget, the increase in the subsidy rate for the 7(a) program is not the result of any Administration proposal. However, we believe there may be opportunities to leverage additional lending in other SBA programs to offset the decreased loan volume in the 7(a) program.

Federal Credit Reform

The Federal Credit Reform Act (FCRA), which became effective in fiscal year 1992, requires Federal agencies to accurately measure the true costs of lending programs by budgeting upfront for the expected net loss to the Government. Prior to credit reform, the cost of Federal loan programs was very uncertain. In many instances, it took years for costs to be apparent. Loan defaults and guarantee claim payments were reflected in the Budget years after loan disbursements and guarantee commitments had been made. The cost of interest subsidies was clear only after several years of experience with market interest rates. The cost of direct loans was systematically overestimated, and the cost of loan guarantees systematically under-estimated.

Credit reform put Federal budgeting and accounting for credit programs on an equal footing by requiring that the cost of loan programs be calculated and recorded up-front in the year that the loan is made or guaranteed. It takes the best information available at a given point in time to measure the budget impact of Federal loan programs. It uses the actual historical cash transactions of loan programs to compare the net present value of payments by the Government (direct loan disbursements and guarantee claims, for example) with the net present value of receipts (such as loan repayments, fees, and recoveries). This allows policy makers to make more informed decisions about credit programs and to compare more accurately the budget impact of credit programs with other Federal expenditures.

Consistent with the Budget Enforcement Act, agencies must also use the technical assumptions derived at the time of the Budget's release for budget execution, which means they must use the default and recovery rates, the discount rate, and other relevant assumptions as provided in the Budget for that fiscal year. This protects the integrity of the analysis – and protects the loan volume provided by Congress – by removing incentives to change the subsidy rate estimate during or after the appropriations process. Credit reform also requires that legislated changes to the subsidy rate be scored accordingly.

Under credit reform, agencies must update their subsidy estimates each year to reflect the actual performance experienced in loan programs. Programs that experience higher costs than projected generate upward cost reestimates, and therefore require an additional mandatory appropriation from the Treasury to cover these losses. Programs experiencing lower costs than projected generate downward cost reestimates, and therefore return excess funds to the Treasury. These reestimates do not require further action in the annual appropriations process.

OMB's Role in Implementing FCRA

The FCRA gives OMB the authority to make subsidy estimates. We have, in many cases, delegated that authority to the agencies, but have retained the right to review and approve all estimates submitted by the agencies as part of their budget formulation and execution.

OMB takes its role very seriously. Staff work to ensure that estimates have been calculated in accordance with the requirements of the FCRA and applicable guidance issued by OMB, Treasury, the Financial Accounting Standards Advisory Board, and other entities. A large part of this role is ensuring that consistent standards are applied to similar programs. To help agencies meet these requirements, OMB has developed a number of tools to estimate and reestimate the cost of credit programs, as well as spreadsheets to assist in end-of-year account calculations. We also provide detailed training, both scheduled and on an as-needed basis, on credit budgeting concepts and applications.

OMB works with agency staff closely throughout the year on issues related to credit subsidy calculation. For example, we assist in developing models for newly enacted programs, or changes to models for existing programs. Recent examples include participation in an overhaul of some of Agriculture's existing cashflow models and developing a new model for the Air Transportation Stabilization loan guarantee program. We are committed to working with agencies to continually improve the accuracy of the subsidy calculations and incorporate new information and modeling theories where appropriate.

During budget formulation, OMB collects and analyzes all subsidy estimates and reestimates to ensure that they have been calculated in accordance with published standards, and that they reflect the program's historical experience. We also ensure that they properly reflect any changes to cashflow models that we have approved prior to budget submission.

SBA and OMB process

SBA and OMB have historically worked together very closely on subsidy estimates. SBA possesses some of the richest credit program data sets in Government, and as a result, their subsidy estimates reflect actual historical performance during a variety of economic conditions. However, as Administrator Barreto will describe in more detail, SBA, like other agencies, is working on improvements to their models and is making excellent progress.

SBA is currently moving towards an econometric model, which will incorporate historical data, programmatic changes, and economic variables. As of now, only two other agencies incorporate elements of econometric modeling. OMB is, in fact, providing staff to assist SBA in developing its econometric model for the 7(a) program for use in the fiscal year 2004 Budget.

I will now turn the discussion over to my colleague, Administrator Barreto, to discuss the specifics of SBA's credit programs. Thank you for the opportunity to appear before you today and I am happy to answer any of your questions.

STATEMENT OF

HECTOR BARRETO
ADMINISTRATOR

U.S. SMALL BUSINESS ADMINISTRATION

SUBSIDY RATE CALCULATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 13, 2002

Good afternoon, Mr. Chairman, Ranking Member Velazquez and members of the Committee. Thank you for this opportunity to discuss the subsidy rates for the SBA's credit programs. I hope that my testimony, and our discussion that will follow, will clear up some of the misconceptions regarding the models and assumptions we use to calculate these rates.

First of all, please allow me to explain what a subsidy rate is. The subsidy rate reflects a program's costs to the government. It is determined by the income (which includes fees, recoveries and prepayment penalties) minus the outflow (i.e., defaults), and the difference is the cost to the government. In theory, a program with a zero subsidy rate would be entirely funded through income and would require no taxpayer subsidization.

I understand your concern about why the SBA's calculation of the subsidy rates has seemed inconsistent with actual performance. The answer is that the subsidy rates reflect the SBA's actual historical performance. The challenge we face, however, is looking into an uncertain future and predicting the average loan performance for the next cohort of loans for each year of life of that cohort. Doing so is akin to predicting the average test score performance for the next class of kindergartners for each year they are in school, all the way through high school 12 years in the future. One approach is to predict the 13 average annual scores by using the data from past years' average scores in grades K through 12. This approach is essentially the same one we have been using to estimate loan performance – we take past performance data from the last 16 years to predict how the next cohort of loans, going forward for 15-20 years, will perform.

Mr. Chairman, I realize that, for nine of the past 10 years, we have experienced net downward re-estimates in the 7(a) program during what proved to be the most extraordinary period of economic expansion in our country's history. Just as the stock market grew faster than the underlying "fundamentals" warranted, this same phenomenon caused the SBA to similarly underestimate the performance of its loan portfolio. The issue in retrospect becomes whether the SBA should have followed the path of irrational exuberance in forecasting over which Chairman Greenspan showed such concern or whether we should have stayed the course and continued to rely on fundamentals. I believe that the SBA followed the more prudent course by relying on the fundamentals.

From 1993 to the present fiscal year, the subsidy rate for the 7(a) program was successively reduced from 5.21 percent to 1.07 percent, based on historical experience. For fiscal year 2003, SBA executed a new interim calculation method, which weights Preferred Lender loans more favorably than non-preferred lender loans and with improved methodology based on SBA's data that reliably delineates the default experience of the two programs. The subsidy rate was consequently lowered by *one-fifth,* all the way to .88 percent, which at the President's $85 million request for 7(a) budget authority would have funded $9.7 billion in lending. The President's plan was to provide record levels of lending to small businesses.

However, P.L. 107-100 subsequently reduced the fees paid by borrowers and lenders for a two-year period beginning in October 2002, causing this subsidy rate to double to 1.76 percent. Since this legislation doubled the cost of providing 7(a) loans, the President's request of $85 million can only fund half as much in 7(a) in lending.

Nevertheless, the SBA is continuing to create a more accurate method of calculating the subsidy rate. Before I discuss our particular solutions, let me review the various methods we considered.

We worked closely with the General Accounting Office (GAO) and the Office of Management and Budget (OMB) to determine the best way to incorporate historical data in calculating subsidy rates. While GAO ultimately disagreed with the interim method chosen by SBA and OMB, both GAO and OMB agreed that the econometric approach is the best method to use. We all agreed that a sound methodology adequately addresses economic fluctuations and programmatic changes while remaining unbiased, producing subsidy estimates that are just as likely to be revised upward as they are downward over a long-term period of time.

The methodological changes we considered in our review fall into three categories: averaging, weighting, and econometric analysis.

Averaging

Averaging, which applies a simple historical average default rate based upon all available data to project the future behavior of all loan cohorts, represents the current 7(a) methodology. This is the method I described at the beginning of my remarks using the test score analogy. GAO has indicated that one of the benefits of the current averaging method is that initial estimates of the subsidy rate are fairly stable because they include more years of historical data that smooth out fluctuations in economic conditions from year to year. However, SBA, OMB and GAO all agree that the simple averaging methodology has limitations. Averages are slow to capture the effects of program changes, which, in the case of 7(a), have likely contributed to the overestimation of defaults.

In our review, we also considered averages based upon shorter look-back periods. We looked back ten, five, and three years to project subsidy costs. Each of these proposals would eliminate data prior to 1992. OMB and SBA believe that truncating the data at an arbitrary point in time has no basis in sound methodology and introduces bias into the subsidy calculation. This bias is particularly acute when the only remaining data represents the greatest economic expansionary period in the history of this nation. Our choice boiled down to using all available historical data or a subset of this data that was clearly an outlier in terms of performance. We made the prudent choice of using all available information.

Weighting

We also considered weighting. By weighting the data by those relevant factors that influence the subsidy rate, one can more accurately represent performance. The most important programmatic factor we were able to isolate was the change in the underwriting standards that resulted from the implementation of the Preferred Lender Program (PLP). Let me explain further.

In 2002, the default assumption was 13.87 percent. The present averaging method treats PLP loans the same as non-PLP loans. However, PLP loans perform better than non-PLP loans, so we needed to find a method that gave PLP this credit. Consequently, our preferred interim method is to weight the data based on the proportion of PLP loans in the database. This method lowered the subsidy rate from 1.07 percent to .88 percent.

However, the weakness of the PLP weighting approach is that it only incorporates one of the programmatic components that affect performance. We know that economic factors also influence loan performance, and this method cannot capture those economic factors. This is why we are moving toward the use of econometric modeling of loan performances. Indeed, this kind of model was designed to produce forecasted estimates that are influenced by economic factors.

Econometric model

One primary difference between the PLP method and the econometric method is the number of relevant factors used to project the subsidy rate. The PLP method uses one programmatic factor, while the econometric model can incorporate a greater number of relevant factors. An econometric model is therefore a more sophisticated weighting method, as it creates a weight for each relevant factor and estimates the subsidy rate based on the relative strengths of these weights.

I am confident that our implementation of the econometric model in FY 2004 will resolve many of the concerns you have. It is a proven model. As I stated, OMB and GAO both agree that it is the most appropriate method to use, and other federal agencies, including the Federal Housing Administration and the U.S. Department of Agriculture, already use it to calculate the subsidy rates for their credit programs. To implement the program, the SBA has contracted with the Office of Federal Housing Enterprise Oversight (OFHEO), an agency which uses such a model to monitor the housing credit markets and the performance of mortgage loans.

Mr. Chairman, thank you for the opportunity to appear here today. I will be happy to answer your questions.

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program
FY 2003 Subsidy Model

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 27, 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 support is especially vital in reviewing the Administration's cost estimates, subsidy assumptions, and fee decisions each year to ensure that the program fees implement the Congressional intent of no program cost to the taxpayer.

We have two objectives in providing this testimony to the Committee. First, NADCO will comment on the FY 2003 SBA 504 subsidy model. This includes the Administration's 504 portfolio performance forecasts.

Second, we will comment on how those forecasts impact user fees, and the resulting impact on the Federal budget.

SBA 2003 Loan Program Performance Forecasts

For the first time since the program went to zero subsidy in 1996, SBA and OMB is increasing the fee borrowers pay to subsidize the 504 program. This comes at a time when SBA's own re-estimates reveal that 504 is paying hundreds of millions of dollars into the Treasury in excessive fees. The fees are derived from the subsidy model, which is in turn based on several forecasts by SBA and OMB officials. Provided here is a brief review of the major model factors.

1. Loan Default Rate:

The factor with the greatest impact on the subsidy model is the default rate, or loan purchase rate forecasted by SBA. In 1996, SBA projected this rate to be about 19%, although there was virtually no history to support this guesstimate. Since that year, SBA has reduced their annual forecasts by over 50%. Unfortunately, even these large reductions have not led to accurate subsidy cost re-estimates for each loan cohort during the years following the loan funding.

For FY 2003, the 504 loan default rate improves from 8.4% down to 8.3%. Attached to this testimony is chart 1 provided by Bank of New York, the 504 program Trustee bank. This chart reveals two significant items. First, prepayments have recently spiked. More on this below. Second, loan defaults have actually remained fairly constant for the last ten years. Monthly defaults have generally been well below twenty to twenty-five loans per month for many years. During this time, our annual loan volume has grown from about $400 million to almost $2.5 billion.

Charts 2 and 3 provide a great deal of insight into 504 defaults. Chart 2 plots loan authorizations and defaults by year. It is clear that, with the exception of three years during and immediately following the 1989-1990 recession, the rate of increase of defaults was generally less than the overall increase in loan volume. Even for last year's recession, the rate of increase from 2000 to 2001 for defaults is less than the loan volume increase.

Chart 3 shows three factors that further clarify actual 504 defaults. Shown is the dollar volume of actual loan defaults by calendar year (see left side scale), from 1986 through 2001. Also shown (see right side scale) is the PERCENTAGE of annual defaults for each year of 504 loans. This is the portion of authorized loans that default each calendar year, and is somewhat different from SBA's data, which is based on fiscal year.

Finally, Chart 3 plots a polynomial equation curve fit for the history of percentage of 504 defaults. This is the mathematical equation that best fits the default percentage data on Chart 3. It is clear that the average percentage of defaults is at or below 4 – 4.5% since the recession years of 1989 – 1991. Even during and just after that recession, 504 defaults did not exceed 5%.

Further supporting our concern about the accuracy of SBA's default 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 statement agrees with our chart that 504 loan defaults have been very consistent for a number of years. At a rate of $2.5 billion in annual loans, this amounts to less than a 5% default rate. We ask the Committee to request reconciliation of this figure with the budget's forecasted factor of 8.3%.

2. 504 Loan Currency Rate:

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 SBA's forecasts for 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.

3. Loan Prepayment Rate:

SBA's forecast of the loan prepayment rate mysteriously increased following FY 2000 from 33% to 51% for FY 2002, and continues to be about 50% for FY 2003. 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 older 504 loans that have higher interest rates than available today. However, the loans that are now prepaying were funded in previous years, and thus not counted for this prepayment forecast. It is clear that 504 prepayments have spiked during the last year, as existing borrowers appear to be re-financing and leaving the 504 loans they took out years ago for lower interest rates in the private markets.

The FY 2003 subsidy model should forecast the EXPECTED rate of prepayments for this fiscal year of loans. The 504 debentures that fund our loans 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 near future, we do not believe that small business borrowers will find lower rates from the private markets, and decide to refinance their 504 loans in the next several years. Therefore, it is not likely the 2003 loan cohort will see a high level of prepayments. Thus, we disagree with SBA's assumption of a prepayment rate of 50% 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.

4. Loan Recovery Rate:

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 ongoing SBA programs that provide virtually all recoveries for 504 defaults. 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. This recovery level was achieved for both the CDC-liquidated loans and those liquidated by SBA's own staff.

The other program, the SBA asset sale program, has resulted in a sale of 872 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 are high collection expenses on the part of the agency. Each of the above initiatives – the CDC liquidation program and the asset sale program – should see very few direct 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.

Additionally, during a recent budget review meeting with SBA, we learned that SBA collection forecasts do not include proceeds from secondary notes by loan guarantors, or notes from new buyers 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 is 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 receivable. This is clearly lowering the overall recovery rate and increasing the future 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.

504 FEES & BUDGET IMPACT

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 liquidation 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 and loan losses. 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 decide to increase the borrower fees when borrowers are actually providing hundreds of millions of dollars to the Federal government. 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 the agency to pay to the Federal Treasury.

In reviewing SBA's and OMB's 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: $396.709 million 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 forecasts 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, recovery, and prepayment 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 Conference Report last year. 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

Thank you for allowing NADCO to provide comments on the 504 subsidy model. 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. Our industry would like to work closely with the Committee to get to the bottom of the forecasting problems in our subsidy models, as revealed by the huge re-estimates calculated by SBA's own staff. We ask that the Committee request further analysis of our subsidy model by the General Accounting Office as soon as possible.

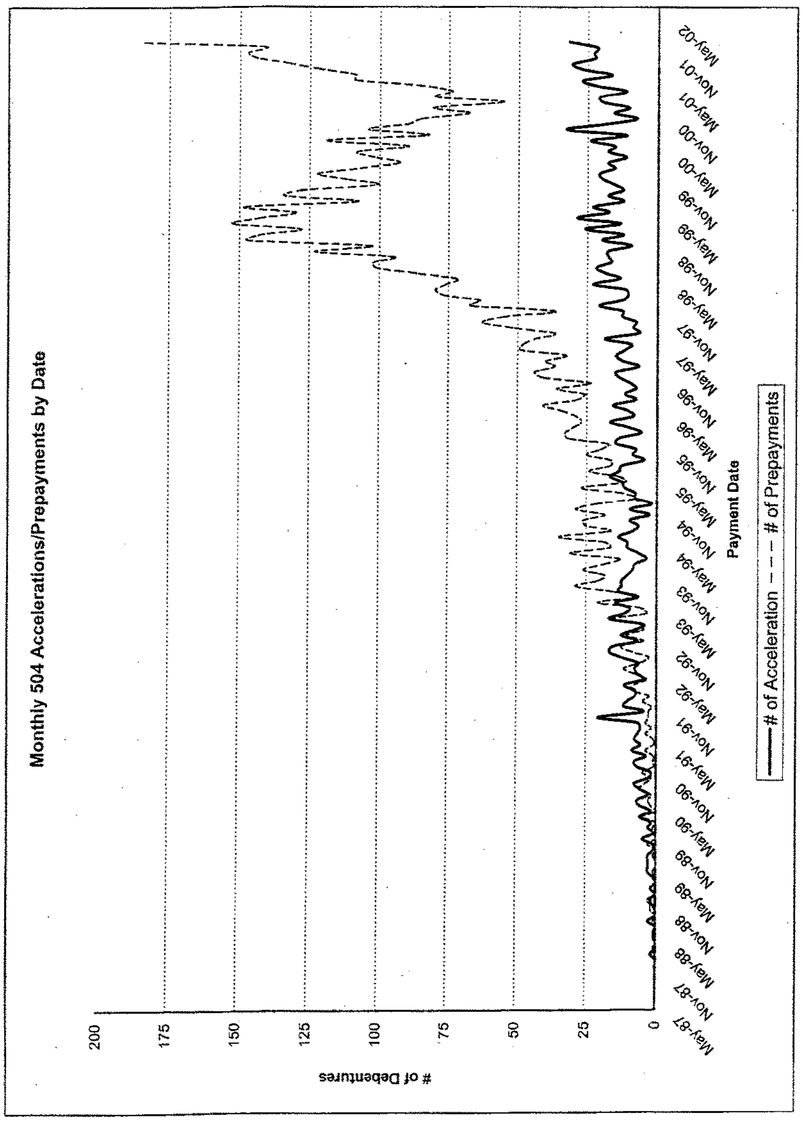

Monthly 504 Accelerations/Prepayments by Date
# of Debentures
200
175
150
125
100
75
50
25
0
May-87
Nov-87
May-88
Nov-88
May-89
Nov-89
May-90
Nov-90
May-91
Nov-91
May-92
Nov-92
May-93
Nov-93
May-94
Nov-94
May-95
Nov-95
May-96
Nov-96
May-97
Nov-97
May-98
Nov-98
May-99
Nov-99
May-00
Nov-00
May-01
Nov-01
May-02
Payment Date
# of Acceleration
# of Prepayments

CHART 1

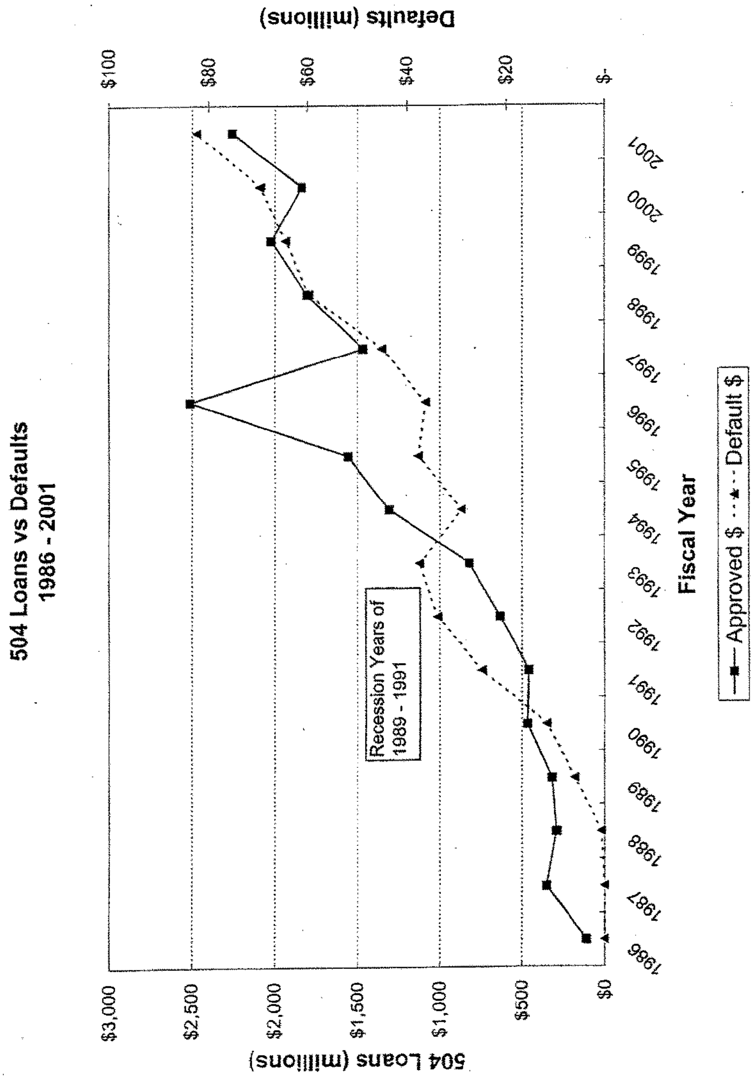

504 Loans vs Defaults
1986 - 2001
Defaults (millions)
$100
$80
$60
$40
$20
$-
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
504 Loans (millions)
Recession Years of
1989 - 1991
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
Fiscal Year
Approved $
Default $

CHART 2

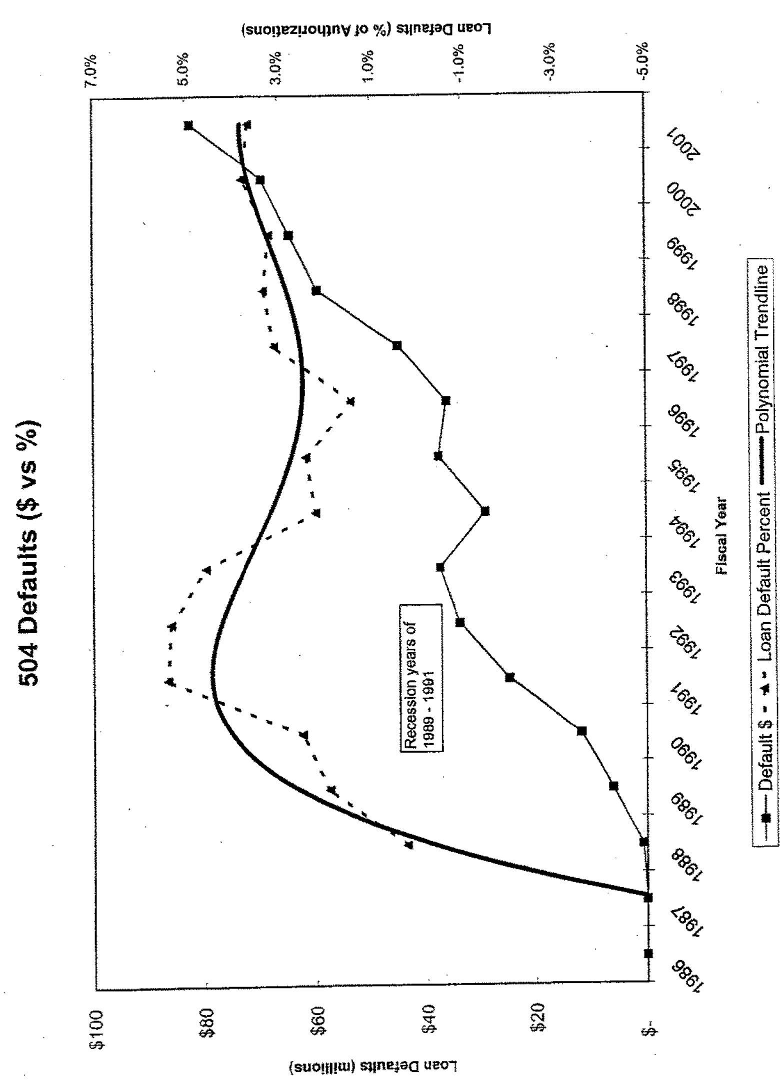

504 Defaults ($ vs %)
Loan Defaults (millions)
$100
$80
$60
$40
$20
$-
Loan Defaults (% of Authorizations)
7.0%
5.0%
3.0%
1.0%
-1.0%
-3.0%
-5.0%
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
Fiscal Year
Recession years of
1989 - 1991
Default $
Loan Default Percent
Polynomial Trendline

CHART 3

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
Stillwater, OK 74076-0332

Wednesday, March 13, 2002

SBA 7(a) Program

Credit Subsidy Re-estimates

Year	Re-estimate $
1995	59
1996	–100
1997	–277
1998	–647
1999	–176
2000	–117
2001	–171
Totals	**-$1,429**

$ in millions

Unweighted Purchase Rates **7(a)**

	(1) Total To Date	(2) Rate in Re-estimate	(3) Expected Total
(as percent of SBA-share disbursed)			
Cohort 1986 (4)	20.29%	20.29%	20.29%
Cohort 1987	19.99%	20.01%	19.99%
Cohort 1988	22.08%	35.78%	22.13%
Cohort 1989	19.99%	20.04%	20.04%
Cohort 1990	20.95%	21.05%	21.09%
Cohort 1991	15.61%	15.78%	15.79%
Cohort 1992	10.24%	10.51%	10.44%
Cohort 1993	7.92%	8.37%	8..25%
Cohort 1994	7.51%	8.24%	7.94%
Cohort 1995	8.28%	9.48%	9.10%
Cohort 1996	8.27%	10.30%	9.97%
Cohort 1997	6.49%	9.90%	9.13%
Cohort 1998	5.59%	11.11%	9.83%
Cohort 1999	3.36%	11.95%	9.24%
Cohort 2000	0.98%	13.14%	8.10%
Cohort 2001	0.04%	13.75%	10.57%

1) Actual Purchase Rate to June 2001 (Annualized).

2) The Re-estimate uses the actual results to date plus the average purchase curve for all cohorts for the cohort's remaining life.

3) The Expected Total is the results to date extended for the cohorts' life by using the slope of the average for all cohorts. Essentially, it is a customized mathematical extension.

4) The 1986 cohort has reached the average maturity of the program; however, minimal amounts of new defaults should be expected.

Table 6.—LOAN GUARANTEES: ASSUMPTIONS UNDERLYING THE FY 2003 SUBSIDY ESTIMATES—Continued

(In percentages, unless noted otherwise)

Agency, Bureau, Program and Risk Category	Subsidy rate	Composition of Subsidy				Loan Characteristics								
		Defaults, net of recoveries	Interest	Fees	All other	Loan maturity (years)	Borrower rate	Grace period (years)	Upfront fees	Annual fees	Other fees	Default rate [1]	Recovery rate [2]	Percent guaranteed
Department of Treasury														
Office of the Secretary:														
Air Transportation Stabilization Board Loan Guarantee	29.26	29.26	....	....	....	7	....	....	....	....	....	39.30	20.00	90.00
Department of Veterans Affairs														
Veterans Benefits Administration:														
Veterans Housing Benefit Program	1.07	4.15	....	−1.82	−1.27	30	6.29	....	[15] 1.76	....	[16] 0.06	10.59	49.98	[17] 25.00
Guaranteed Loan Sale Securities	5.18	5.14	....	....	0.03	30	6.29	....	....	....	....	15.07	60.00	100.00
International Assistance Programs														
Agency for International Development:														
Development Credit Authority	6.44	8.87	....	−2.43	....	10	4.91	....	0.50	0.50	....	12.18	....	50.00
Overseas Private Investment Corporation:														
OPIC Guarantees	1.70	9.09	....	−7.39	....	11	....	2	0.50	2.00	....	15.00	50.00	100.00
Small Business Administration														
General Business Loan Programs:														
7(a) General Business Loans	1.76	4.21	....	−2.37	−0.08	14	10.50	....	2.37	0.25	....	9.38	57.95	73.75
7(a) General Business Loans—DELTA	2.40	4.84	....	−2.37	−0.08	14	10.50	....	2.37	0.25	....	....	....	73.75
Section 504 Certified Development Companies Debentures	....	3.02	....	−5.62	2.59	19	5.86	....	0.70	0.57	....	8.32	19.97	100.00
Section 504 Certified Development Companies Debentures—DELTA	0.88	3.48	....	−5.58	2.98	19	5.86	....	0.70	0.57	....	9.57	19.97	100.00
Section 7(m) Microloan Guaranty	8.42	1.82	....	....	6.61	10	3.88	5	....	....	....	5.09	50.01	100.00
SBIC Debentures	....	9.45	....	−3.08	−6.37	10	9.29	....	3.08	0.89	....	25.00	60.00	100.00
SBIC Participating Securities	....	6.58	....	−3.08	−3.50	10	7.85	....	....	7.65	1.31	....	....	100.00
SBIC New Markets Venture Capital	15.46	15.46	....	....	....	10	....	....	....	....	....	40.00	54.00	100.00
Other Independent Agencies														
Export-Import Bank of the United States:														
Short, Medium, and Long Term Guarantees and Insurance Program	5.52	11.34	....	−5.81	....	5	4.50	4	6.03	0.13	....	19.09	17.00	100.00
Presidio Trust:														
Presidio Trust Loan Guarantee Program	0.13	0.63	....	−0.50	....	20	....	....	0.50	....	....	15.00	70.00	75.00

* Nonzero amount rounds to zero, based on units for this column.
[1] Lifetime defaults as a percentage of disbursements.
[2] Recoveries as a percentage of lifetime defaults.
[3] Reflects a weighted average, fees range from 1 percent to 2 percent.
[4] Subsidized and unsubsidized Stafford loans include a six month grace period.
[5] Recoveries include interest.
[6] The Government guarantees 98 percent of principal for private lenders and 95 percent for guaranty agencies.
[7] Rates are set at the weighted rate of the loans consolidated, rounded up to the nearest eighth of a percent.
[8] Sallie Mae pays the Department of Education a fee amount specified in statute. This fee is calculated annually in an amount equal to 0.30 percent of the principal amount of each loan made, insured, or guaranteed under the FFEL program that Sallie Mae holds, provided that the loan was acquired on or after August 4, 1993 (the date of enactment of the Student Loan Reform Act, which created the fee).

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 and the Bureau of Labor Statistics reviewed 1998 7(a) loans and determined that 200,000 net jobs were created by this cohort of loans. This means 1 new job for every $53,895 in disbursed 7(a) 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.

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 30 basis points, or .30. 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. 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 $260 million has been returned to Treasury. This means OMB HAS DISREGARDED THE ANNUAL APPROPRIATIONS PROVISIONS AND USED THE MONEY FOR OTHER PURPOSES.

"Smoke and Mirrors" Accounting

Attached to this testimony are several charts. The first chart (page 1 of the testimony) details the re-estimates for the SBA 7(a) program since 1995. The number totals $1.429 billion! NAGGL has been complaining for years that the basic subsidy rate materially overstates the government's cost of the program. Based on information NAGGL recently obtained (see the attachment "un-weighted purchase rates"), you can see that OMB is not telling the whole truth even in the re-estimate process. The chart shows that OMB uses default estimates in the re-estimate process that are substantially higher than the "expected" purchase rate for fiscal years 1995 through 2001! NAGGL estimates that if the "expected" purchase rates were used in the re-estimate process, and additional $400-$600 million in downward re-estimates. The total downward re-estimates in the 7(a) program would then approximate the number that Dr. Blanchard testified to at the September 5, 2001 roundtable.

Another question arises from Table 6 of the Federal Credit Supplement to the FY 2003 Budget. This table reports a default estimate for SBA 7(a) loans to be made in FY 2003 of 9.38%. Yet in the subsidy calculations, OMB requires the use of a 12.87% default estimate. Why?

The 9.38% default estimate would fall in the range of defaults (8%-10%) that the SBA CFO's office testified to in 2000. A 9.38% default rate would be slightly higher (according to GAO) than the average default rate for loan cohorts 1992 forward. A 9.38% default rate would reduce the FY 2003 7(a) subsidy rate by over 100 basis points, leading to a subsidy rate of less than .75% rather than the 1.76% reported by OMB. Why was the 9.38% default estimate not used?

Lastly, OMB reports that the government would be saving money by moving large loans out of the SBA 7(a) program and into the SBA 504 program. Yet SBA 7(a) loans pay higher fees to the government than do SBA 504 loans. It is clear that large SBA 7(a) loans are used to offset the costs of small 7(a) loans. Moving large loans out of the SBA 7(a) program will cause the SBA 7(a) subsidy rate to rise SUBSTANTIALLY in the FY 2004 budget.

So this "smoke and mirrors" accounting scheme means one of two things. Either OMB is trying to shut down the SBA 7(a) program – move large loans out of the 7(a) program, drive up the subsidy costs on small loans, force lenders out of the program – or this is a punitive budget request for the SBA 7(a) legislative efforts made over the last year. Whichever it is, it is a bad budget for small businesses that need access to capital!

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 made 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 Request

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. NAGGL would support a modification to the Federal Credit Reform Act to have the subsidy calculated by an independent third party. Perhaps we should try a "pilot" revolving fund for the SBA 7(a) program. It is clear to us at NAGGL that, until OMB is 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. Substantially more than 100% of the dollars appropriated for the 7(a) program since 1995 have been returned to the Treasury. This is not right. This is not fair. **OMB IS LEVYING AN UNAUTHORIZED TAX. IT IS TIME FOR A SOLUTION!**

Enclosure

Briefing Before the Staffs of the Senate and House Committees on Small Business

GAO
Accountability * Integrity * Reliability

Briefing to Staff of the Senate and House Committees on Small Business

Small Business Administration

Section 7(a) General Business Loans Credit Subsidy Estimates

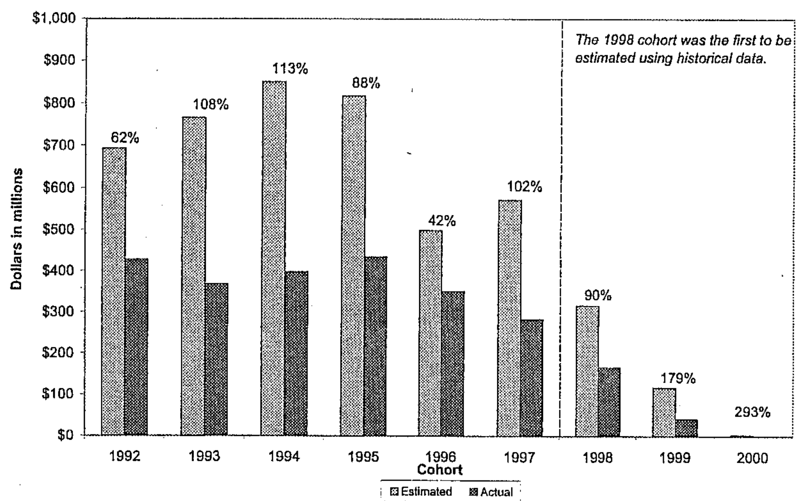
July 30, 2001

1

GAO
Accountability * Integrity * Reliability

Comparison of Originally Estimated Defaults and Recoveries to Actual Data

Percentage by which Originally Estimated Defaults were more than Actual Defaults for Fiscal Years 1992 through 2000 (Cumulatively by Cohort)



Source: GAO analysis based on SBA data.
Note: By the end of fiscal year 2000, only the 1992 through 1996 cohorts had reached the typical peak default years, which historically have been years 3 through 5 after approval.

GAO
Accountability * Integrity * Reliability

Causes of Differences

- For the 1992 through 1997 cohorts,[11] the specific reason for the differences between originally estimated and actual defaults is unclear because the basis of the estimate is unknown.
  - SBA did not begin to use its historical data until 1996, when it calculated the original subsidy cost estimate for the 1998 cohort.
  - According to SBA officials, prior to 1996, subsidy cost estimates were prepared based on direct consultation with OMB and the basis used for the default estimates was not documented.
  - However, SBA believes one of the reasons for the differences was an unexpected good economy.

[11] Reestimates of the 1992 through 1997 cohorts have accounted for 84 percent of the 7(a) program's total downward reestimate.

GAO
Accountability * Integrity * Reliability

- 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 1996 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.

GAO
Accountability * Integrity * Reliability

- 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.

a Reesi mount *In Thoi*

Includes principal only and Technical Re-estimates

	1997 Budget	1998 Budget	1999 [illegible]	2000 Budget	2001 Budget	2002 Budget	2003 Budget	Cumul[illegible] Change
1992 Cohort	$ 4,699	$ (55,389)	$ (29,806)	$ (73,695)	$ (4,711)	$ (4,183)	$ (4,711)	$ (167,796)
1993 Cohort	$ (14,139)	$ (77,011)	$ (50,462)	$ (79,558)	$ (20,211)	$ (16,085)	$ (6,641)	$ (264,107)
1994 Cohort	$ 52,891	$ (13,610)	$ (62,959)	$ (60,366)	$ (11,505)	$ (4,376)	$ (4,323)	$ (104,248)
1995 Cohort	$ 10,547	$ 48,620	$ (68,391)	$ (59,836)	$ (774)	$ (3,619)	$ (13,614)	$ (87,067)
1996 Cohort		$ 32,401	$ 37,280	$ (101,090)	$ (15,994)	$ (9,349)	$ (86)	$ (56,838)
1997 Cohort			$ (23,836)	$ (86,258)	$ (38,550)	$ (133)	$ (31,550)	$ (180,327)
1998 Cohort				$ (52,221)	$ (39,472)	$ (39,467)	$ (13,376)	$ (144,536)
1999 Cohort					$ (13,018)	$ (11,392)	$ (44,330)	$ (68,740)
2000 Cohort						$ (2,526)	$ 4,390	$ 1,864
2001 Cohort							$ (21,586)	$ (21,586)
Total Change	$ 53,998	$ (64,989)	$ (198,174)	$ (513,024)	$ (144,235)	$ (91,130)	$ (135,826)	$ (1,093,381)

Total Re-estimate Amount *(Dollars in Thousands)*

Prin. Only Re-Estimate	$ 53,998	$ (64,989)	$ (198,174)	$ (513,024)	$ (144,235)	$ (91,130)	$ (135,826)	$ (1,093,381)
Interest	$ 3,454	$ (35,092)	$ (74,093)	$ (122,319)	$ (27,213)	$ (24,492)	$ (35,656)	$ (315,411)
Interest on Re-estimate	$ 1,284	$ -	$ (4,618)	$ (11,467)	$ (3,032)	$ (1,902)	$ (3)	$ (19,738)
Total Re-estimate Amount	$ 58,737	$ (100,081)	$ (276,885)	$ (646,810)	$ (174,480)	$ (117,524)	$ (171,485)	$ (1,428,529)

7a Subsidy Rate Reestimates

	Execution Rate	1997 Budget	1998 Budget	1999 Budget	2000 Budget	2001 Budget	2002 Budget	2003 Budget
Cohort 1992 (Technical)	4.85%	4.94%	3.88%	3.31%	1.90%	1.81%	1.73%	1.64%
(Interest)		5.38%	5.38%					
Cohort 1993 (Technical)	5.21%	4.97%	3.67%	2.82%	1.48%	1.12%	1.06%	0.76%
(Interest)		5.43%	5.43%					
Cohort 1994 (Technical)	2.15%	2.91%	2.70%	1.82%	0.98%	0.82%	0.76%	0.74%
(Interest)		2.19%	2.19%					
Cohort 1995 (Technical)	2.74%	2.97%	3.61%	2.61%	1.77%	1.76%	1.71%	1.52%
(Interest)		2.95%	2.97%					
Cohort 1996 (Technical)	1.06%		2.40%	2.17%	0.58%	0.34%	0.20%	0.20%
(Interest)			1.07%	1.06%				
Cohort 1997 (Technical)	1.93%			1.39%	0.44%	0.02%	0.03%	-0.36%
(Interest)						2.23%		
Cohort 1998 (Technical)	2.14%				1.00%	0.88%	0.41%	0.24%
(Interest)						1.23%		
Cohort 1999 (Technical)	1.39%					1.03%	1.12%	0.59%
(Interest)						1.37%	0.89%	
Cohort 2000 (Technical)	1.16%						1.10%	1.18%
(Interest)								1.09%
Cohort 2001 (Technical)	1.17%							0.71%
(Interest)								

Assumptions for the SBA 7(a) Subsidy Model

There are 13 variables currently tracked in the 7(a) cash flow model. There are approximately 100 supporting forecast and technical assumptions. These ssumptions are provided in the table below. Approximately 450 formulae are used to calculate the impact of these assumptions over time which are in turn pported by approximately 4,000 formulae used to calculate historical data on each cohort of loans captured in the SBA database. The database covers all a) loan activity since 1989 and consists of 13 million transactions for approximately 500,000 loans. The figures below represent non-discounted dollar totals as they **currently appear in the agency cash flow model, and do not reflect any additional or subsequent analysis.** The OMB model discounts these cash flows in calculating subsidy rate.

	FY 1996 Exec.	FY 1997 Exec.	FY 1998 Exec.	FY 1999 Exec.	FY 2000 Exec.	FY 2001 Exec.	FY 2002 Curr. Svc.	FY 2003 Request
Discount Rate[1]								
–Year 0	6.60%	5.84%	6.35%	6.03%	5.01%	n/a	n/a	n/a
–Year 1	6.60%	7.01%	6.11%	6.03%	5.01%	n/a	n/a	n/a
–Year 2	6.60%	5.18%	5.72%	6.03%	5.01%	n/a	n/a	n/a
–Year 3	6.60%	5.10%	5.44%	6.03%	5.01%	n/a	n/a	n/a
Guaranty Percentage								
–Average Guarantee Percentage	75.75%	75.75%	76.05%	73.37%	72.88%	74.98%	73.74%	73.75%
Average Maturity[4]	**12 years**	**13 years**	**12 years**	**12 years**	**14 years**	**14 years**	**14 years**	**14 years**
Loan Maturity Composition (As Percent of Approvals)								
<1 year	N/A	N/A	1.00%	1.31%	2.88%	5.81%	6.30%	5.41%
1<8 years	N/A	N/A	32.00%	28.47%	30.79%	n/a	n/a	n/a
8<12 years	N/A	N/A	19.00%	17.79%	17.10%	n/a	n/a	n/a
12<18 years	N/A	N/A	10.00%	14.04%	15.38%	n/a	n/a	n/a
18<22 years	N/A	N/A	13.00%	14.40%	14.89%	n/a	n/a	n/a
22 < years	N/A	N/A	25.00%	23.99%	21.84%	n/a	n/a	n/a
Cancellation Rate	**5.00%**	**10.00%**	**12.00%**	**13.00%**	**12.50%**	**12.50%**	**13.29%**	**13.44%**
Disbursement Rates								
–Year 1	68.42%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%
–Year 2	31.58%	45.00%	45.00%	45.00%	45.00%	45.00%	45.00%	45.00%
Weighted Average Upfront Fee Rate	**2.97%**	**2.97%**	**2.97%**	**2.85%**	**2.80%**	**2.85%**	**2.74%**	**2.37%**
Fee Structure (Effective 12/22/2000)								
Gross Loan amount less than or equal to $150,000 (with bank retention)						1.50%	1.50%	1.50%
Gross Loan amount greater than $150,000 and less than or equal to $700,000						3.00%	3.00%	2.50%
Gross Loan amount greater than $700,000						3.50%	3.50%	3.50%
Loan Mix Projection (loans over one year):								
Gross Loan amount less than or equal to $150,000						19.08%	17.44%	18.70%
an amount greater than $150,000 and less than or equal to $700,000						53.52%	41.86%	43.76%
an amount greater than $700,000						24.64%	34.40%	32.13%
Average Loan Sizes (for calculating weighted avg. fee):[2]								
Gross Loan amount less than or equal to $150,000						$ 74,370	$ 66,107	$ 37,684
Gross Loan amount greater than $150,000 and less than or equal to $700,000						$ 299,992	$ 299,992	$ 306,719
Gross Loan amount greater than $700,000						$ 660,000	$ 660,000	$ 804,312
–Under $80,000	N/A	N/A	N/A	$ 24,171	$ 43,511			
–$80,000 - $150,000					$ 113,109			
–$150,000 - $250,000	N/A	N/A	N/A	$ 149,727	$ 195,187			
–$250,000 - $500,000	N/A	N/A	N/A	$ 348,250	$ 347,084			
–Over $500,000	N/A	N/A	N/A	$ 655,447	$ 652,755			
Disbursement Distribution (for calculating weighted avg. fee):								
–Loans with a Maturity under 1 Year	N/A	N/A	N/A	2.75%	3.97%			
–Under $80,000	N/A	0.00%	18.00%	19.61%	22.49%			
–$80,000 - $150,000					17.36%			
–$150,000 - $250,000	N/A	35.00%	24.00%	28.85%	9.68%			
–$250,000 - $500,000	N/A	30.00%	26.00%	25.86%	17.55%			
–Over $500,000	N/A	35.00%	32.00%	22.93%	28.95%			
Fee Stucture (for calculating weighted avg. fee):[2]								
–Under 1 Year	N/A	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
–Under $80,000 Loans	N/A	2.00%	2.00%	2.00%	2.00%			
–Loan Portion $80,000-250,000	N/A	3.00%	3.00%	3.00%	3.00%			
–Loan Portion $250,000-$500,000	N/A	3.50%	3.50%	3.50%	3.50%			
–Loan Portion over $500,000	N/A	3.88%	3.88%	3.88%	3.88%			
Annual Interest Pass Through Fee Rate								
Gross approval less than or equal to $150,000	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.25%
Gross approval more than $150,000	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.55%	0.25%
Secondary Market Premium	N/A	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%	50.00%
Income on Loans Sold in Secondary Market as % of Disbursements	N/A	0.02%	0.04%	0.02%	0.05%	0.0025%	0.0025%	0.0025%
Interest Rate to Borrower, Base (Prime)								
–Year 1	N/A	7.00%	7.50%	7.50%	8.50%	8.50%	8.50%	8.50%
–Year 2	N/A	7.00%	7.25%	7.25%	8.50%	8.50%	8.50%	8.50%
Average Premium Above Prime Rate	N/A	2.50%	2.00%	2.00%	2.00%	1.71%	1.70%	1.71%
ent Rate (As a percent of Outstanding Balance)[5]								
	N/A	N/A	3.85%	4.65%	12.41%	4.15%	4.83%	4.34%
[illegible]	N/A	N/A	9.64%	10.07%	11.66%	8.96%	9.12%	9.46%
–Year 3	N/A	N/A	11.00%	13.91%	8.75%	13.44%	13.59%	13.95%

Year 4	N/A	N/A	11.00%	14.24%	8.34%	14.56%	14.85%	15.12%
Year 5	N/A	N/A	11.00%	14.76%	7.83%	13.66%	15.03%	15.63%
Year 6	N/A	N/A	11.00%	14.36%	8.48%	13.96%	15.67%	15.92%
	N/A	N/A	11.00%	12.68%	8.70%	12.22%	14.58%	14.77%
	N/A	N/A	11.00%	13.49%	9.13%	11.56%	13.86%	14.31%
	N/A	N/A	11.00%	10.05%	8.25%	12.33%	14.78%	14.84%
Year 10	N/A	N/A	11.00%	14.00%	3.80%	16.15%	16.03%	16.24%
Year 11	N/A	N/A	11.00%	13.44%	3.80%	13.48%	12.00%	13.75%
Year 12	N/A	N/A	11.00%	13.44%	3.80%	13.48%	12.00%	13.75%
Year 13	N/A	N/A	11.00%	13.44%	3.80%	13.48%	12.00%	13.75%
xpected Default Payment (Purchase) Rate	**17.26%**	**17.25%**	**16.00%**	**15.05%**	**14.42%**	**14.29%**	**13.87%**	**12.73%**
istribution of Default Payments (Purchases)								
Year 1	0.46%	0.06%	0.09%	0.07%	0.07%	0.06%	0.05%	0.05%
Year 2	3.02%	1.83%	1.80%	1.77%	1.75%	1.63%	1.58%	1.33%
Year 3	4.23%	4.31%	3.89%	3.88%	3.71%	3.76%	3.64%	3.14%
Year 4	2.09%	3.82%	3.47%	3.41%	3.24%	3.17%	3.11%	2.73%
Year 5	0.46%	2.66%	2.45%	2.31%	2.19%	2.17%	2.13%	2.02%
Year 6	4.29%	1.71%	1.62%	1.51%	1.43%	1.42%	1.38%	1.34%
Year 7	0.90%	1.05%	1.03%	0.91%	0.85%	0.85%	0.83%	0.81%
Year 8	0.68%	0.62%	0.60%	0.51%	0.48%	0.49%	0.47%	0.44%
Year 9	1.05%	0.35%	0.35%	0.27%	0.27%	0.30%	0.27%	0.31%
Year 10	0.08%	0.23%	0.25%	0.18%	0.18%	0.20%	0.17%	0.20%
Year 11		0.11%	0.14%	0.11%	0.09%	0.11%	0.09%	0.11%
Year 12		0.17%	0.12%	0.09%	0.09%	0.08%	0.06%	0.08%
Year 13		0.18%	0.04%	0.03%	0.05%	0.04%	0.05%	0.08%
Year 14		0.10%	0.10%		0.02%	0.01%	0.02%	0.05%
Year 15		0.05%	0.05%				0.02%	0.01%
								0.00%
:xpected Recovery Rate	**56.46%**	**51.00%**	**51.70%**	**60.95%**	**60.53%**	**60.65%**	**60.28%**	**57.95%**
Distribution of Net Recoveries on Defaults								
Year 1	0.23%	0.03%	0.02%	0.01%	0.01%	-0.20%	0.03%	0.04%
Year 2	0.98%	0.87%	0.77%	0.71%	0.68%	0.63%	0.64%	0.44%
Year 3	3.93%	5.07%	3.15%	3.26%	3.09%	2.91%	2.86%	2.53%
Year 4	5.85%	6.82%	5.70%	6.17%	5.58%	5.40%	5.47%	5.31%
Year 5	4.92%	6.53%	6.85%	7.55%	6.97%	6.73%	6.71%	6.85%
Year 6	6.59%	5.50%	5.83%	6.84%	6.48%	6.44%	6.33%	6.56%
	8.35%	5.67%	5.78%	7.06%	6.74%	6.93%	6.76%	6.87%
	6.19%	3.93%	4.94%	6.06%	5.84%	5.89%	6.01%	6.16%
	4.36%	3.21%	4.13%	5.27%	4.91%	4.94%	5.02%	4.66%
Year 10	5.42%	2.98%	3.53%	5.13%	4.55%	4.43%	4.43%	4.00%
Year 11	3.25%	1.76%	2.25%	3.16%	3.81%	3.79%	3.53%	3.10%
Year 12	1.57%	1.72%	1.79%	2.87%	3.37%	3.49%	3.21%	2.92%
Year 13	1.24%	1.70%	1.53%	2.85%	3.10%	3.50%	3.19%	2.58%
Year 14	0.67%	1.56%	1.63%	1.95%	2.83%	2.17%	2.69%	2.53%
Year 15	0.41%	1.30%	1.35%	1.31%	2.56%	2.03%	1.75%	2.16%
Year 16	0.39%	1.04%	1.08%	0.68%		1.57%	1.65%	0.71%
Year 17	0.38%	0.78%	0.81%	0.04%				0.34%
Year 18	0.37%	0.52%	0.54%					0.19%
Year 19	0.58%							
Year 20	0.28%							
Year 21	0.22%							
Year 22	0.12%							
Year 23	0.05%							
Year 24	0.05%							
Year 25	0.04%							
Year 26	0.01%							

In FY 2001, a single discount rate was replaced by OMB's "Basket of Zeros" resulting in a weighted average discount rate.
As of 12/2000, The average loan size variable was collapsed into 3 categories to match new fee tables created by legislation.
This includes the effects of P.L. 107-100 passed in December, 2001
The loan maturity composition was replaced by Weighted Average Maturity
The Prepayments are not totaled since they are divided by outstanding principal balance at the end of each year.

DRAFT - Unvalidated
7a Subsidy Rate
Preliminary Crosswalk for FY 2003 Baseline

		Change in Rate	Rate
Baseline Rate for 2002			**1.07%**
Defaults decrease from 13.87% to 12.73%		-0.34%	
Recoveries change from 60.28% to 57.95%		0.02%	
Change in Prepayments from 62.88% to 64.94% (Percent of initial disbursement)		0.03%	
Mean Guarantee percentage changes from 73.74% to 73.75%		0.00%	
Change in average loan sizes and volume mix not otherwise included		0.03%	
Effect of PL 107-100		0.88%	
Ongoing fee changed from .50% to .25%			
Upfront Fee change:			
Loans <$150k:	*2.0% to 1.0%*		
Loans >$150k =<$700k:	*3.0% to 2.5%*		
Loans >$700k	*3.5% to 3.5%*		
Interactive Effect		-0.02%	
Change in Discount Rates		0.09%	
Baseline Rate for 2003			**1.76%**
Net Increase / decrease		*0.69%*	

Sensitivity Analysis for 7(a) Guarantee

	Subsidy Rate Effect	
	(+1)%	**(-1)%**
1. Purchase Rate Change	0.30	-0.30
2. Recovery Rate Change	-0.07	0.07
4. Average Maturity Change *(Assume a 1 year increase)*	-0.07	0.07
5. Average Guarantee Percentage Change	0.02	-0.02
6. Prepayment Rate Change	0.06	-0.06

TABLE 6: 7(a) SENSITIVITY TO KEY VARIABLES

NOVEMBER 22, 2001
Bacon's

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

AMERICAN BANKER
THE FINANCIAL SERVICES DAILY

2/12/02
P. 1

In Bush Plan, A Hidden Cut For SBA Loans

■ BY NICOLE DURAN

WASHINGTON — Defenders of the Small Business Administration's principal loan guarantee program are girding for battle — again — as President Bush's budget proposes scaling back the flagship program.

Lenders won last year when Congress reduced 7(a) program fees for the 2002 fiscal year and rejected the President's proposal to finance the program completely with those fees.

When President Bush released his budget plan for fiscal 2003 last week, his SBA proposal looked innocuous enough: $798 million to run the agency, a 3.8% increase. But a closer look shows that if lawmakers approve it as written, the amount of small-business loans the agency could back next year would be halved, to $4.85 billion.

"The President's budget request for the SBA has some strong points, but cutting the 7(a) guaranteed business loan program at the same time the Federal Reserve Board is reporting that banks have tightened business loan credit standards makes no sense," Sen. Christopher S. "Kit" Bond, said in a release Friday. The Missourian is the ranking Republican on the Senate Small Business Committee.

The cut was hard to find because one has to look at the subsidy rate — what the government projects that it costs to administer the program and cover losses per $100 lent.

"It's not there in black-and-white," said committee spokesman J. Craig Orfield.

How that rate is calculated has been a source of debate between lenders' groups, such as the National Association of Government Guaranteed Lenders, and the White House for years, and it is sure to come up during a House Small Business Committee hearing on budget matters Wednesday.

Scheduled witnesses include SBA Administrator Hector V. Barreto Jr. and the lender association's president, Anthony R. Wilkinson.

The Office of Management and Budget sets the formula that the SBA must use to determine what is needed for reserves to cover losses and for administrative overhead. Critics say it overestimates defaults and forces lenders and borrowers to pay too much in fees — some of which end up in the general Treasury for use on non-SBA items.

The General Accounting Office agreed in a report issued last summer, saying that the SBA and the Office of Management and Budget have overestimated the cost of the 7(a) program by $958 million, and counting, since 1992.

"They did it to us again," Mr. Wilkinson said. "We were overcharged $164 million in 2001."

The current rate is 1.07, which means the government sets aside $1.07 for every $100 in loans it guarantees. This year the agency has set aside $107 million to back $10 billion of loans.

The subsidy rate would have been 0.88 for 2003 had Congress not reduced fees. That curtailed the income to the program and forced the OMB to raise the rate to 1.76 to cover the difference, an SBA official said.

That distressed officials at the Senate Small Business Committee, which said the OMB had promised Congress last fall to lower the rate to between 0.1 and 0.5 for next year.

So, even though the proposed budget would increase the program's direct appropriation by 9%, to $85 million, the agency can collect far fewer fees than in 2002. Fees and the appropriation combined represent all the SBA's income.

Mr. Wilkinson said that the subsidy formula requires lenders and borrowers to overpay so much that every dollar appropriated for the 7(a) program since 1992 has actually returned to the Treasury.

"It all goes back to OMB's effort to tax small businesses and use appropriated funds for other purposes," he said.

According to the SBA, it has contracted with outside economists to develop an "econometrics" system to calculate the subsidy rate. The new system should solve the argument in time for the fiscal 2004 budget, the agency said.

Some on the Hill are skeptical, however.

Paul Cooksey, a staff member on the Senate Small Business Committee, said a similar promise made in 1998 remains unfulfilled. ■

Insert1

Effect of Asset Sales on Subsidy Rate Calculation

The U. Small Business Administration's (SBA) Asset Sale Program portfolio has included 7(a), 504, Disaster business, home and many pre-credit reform direct loans from the pre-credit reform and credit reform portfolios. The data from these sales was incorporated into the estimates and re-estimates where possible. At this time, however, the data has not led to any significant conclusions as to the long-term effect of asset sales. Therefore, in preparing the budget we assumed that asset sales would have essentially a neutral effect on the subsidy rate.

Insert 2

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%

Insert 3

What is the Administration willing to do to change the assumptions / methodology / subsidy rate for 7(a) and 504 prior to the enactment of the FY 2003 Budget?

- The Federal Credit Reform Act of 1990 (FCRA) requires agencies to use the "current" assumptions for budget execution, which are defined in the Budget Enforcement Act[1] as those assumptions included in the most recent President's Budget. Therefore, agencies cannot change their economic or technical assumptions (i.e., default and recovery rates) underlying the subsidy cost estimate after submission of the President's Budget to Congress.

- This prohibition is supported by sound rationale. Prohibiting changes to the current assumptions:

    - Reduces volatility in subsidy estimates, which could make it difficult for the President and the Congress to provide sufficient budgetary resources for credit and other Federal programs.

    - Protects the integrity of the technical analysis by removing incentives to lower the subsidy estimate during the appropriations process and budget execution.

    - Establishes uniform rules for all Federal credit programs.

- The FCRA does provide a mechanism to reestimate subsidy costs each year.

    - To reestimate the cost of the loan portfolio, agencies must update their subsidy models in accordance with the actual performance experienced in the loan programs each year. Upward adjustments are funded from permanent, indefinite budget authority, which does not require appropriations. These upward adjustments do not affect agencies' discretionary appropriations. Downward adjustments are returned to the general fund of the Treasury.

    - In addition to incorporating actual loan performance, agencies apply the actual annual discount rate to reestimate the subsidy cost of prior year loans.

    - The 7(a) General Business Loan Program has experienced a trend in downward reestimates, which is likely due to the unprecedented economic expansion over the last several years. However, the expectation is that over the life of a loan portfolio, upward and downward re-estimates will be even.

- The mandate is included in the following FCRA sections:

---

[1] The Budget Enforcement Act of 1990 amended the Balanced Budget and Emergency Deficit Control Act of 1985

§ 502(5)(F): When funds are obligated for a direct loan or loan guarantee, the estimated cost shall be based on the current assumptions, adjusted to incorporate the terms of the loan contract, for the fiscal year in which the funds are obligated.

§ 502(10): The term "current" has the same meaning as in section 250(c)(9) of the Balanced Budget and Emergency Deficit Control Act of 1985.

Insert 4

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.

O