United States Senate
WASHINGTON, DC 20510

November 20, 2008

The Honorable Henry M. Paulson Jr.
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Paulson:

We write to you today to express our concerns regarding the deteriorating state of the Small Business Administration's (SBA) loan programs. We urge you to take immediate action to address the crisis facing these programs and the small business borrowers who rely upon them for essential financing. The SBA's 7(a) and 504 loan guarantee programs—the largest single source of long-term small business financing in our economy—have historically provided a lifeline to small businesses during recessions and times of economic peril. However, that is not the case today as loan volume—in terms of the numbers of loans made and dollar volume loaned—decreased significantly during the last fiscal year in each program. As you would expect, the pace of the decline continues to worsen this year, with 7(a) loans down 53 percent compared to this time last year.

While declining borrower demand is one reason for the decrease in loan volume, there are more significant factors at work. First, the secondary market for well-performing 7(a) and 504 loans is now paralyzed. With no secondary market for SBA loans, small business lenders have been cut off from a critical source of funding, and, as a result, lenders are now unable to make new loans. Second, many small business lenders and borrowers now find that the cost of SBA loans is prohibitive. While we continue to work with the SBA on the latter issue, we urge you to help immediately address the former by purchasing well-performing pooled SBA loans out of the secondary market.

In a healthy secondary market, loan poolers purchase 7(a) and 504 loans and use these loans to create pools of pass-through securities that are sold to investors. Investors who buy SBA backed securities are attracted by the mitigated risk of SBA loans which are backed by a Federal guarantee as high as 85 percent. Traditionally, the primary source of funding for most SBA pool investors has been the London Interbank Offered Rate (LIBOR), the interest rate at which lenders can borrow money from other banks. Unfortunately, the spread between LIBOR and the Wall Street Journal Prime Rate—the rate at which SBA 7(a) loans have historically been made—has narrowed this year. Consequently, investors are now shunning SBA guaranteed loans for securities that can offer higher interest rates. This has frozen secondary markets and dramatically reduced the amount of liquidity lenders have to make loans to small firms.

As potential investors have abandoned the secondary market for SBA securities, lenders have been forced to hold SBA loans on their books instead of selling them in the secondary market to obtain additional funds for new lending. Broker-dealers now have large inventories of illiquid SBA loans. Unfortunately, the brokers' capacity to carry this inventory appears to be exhausted, leaving them unable to purchase new SBA loans thus forcing many lenders to significantly curtail or, in some cases, even stop making SBA loans to small firms.

The problem is similar in the SBA's 504 loan program. In a typical 504 loan transaction, a small business borrower approaches a bank to fund plant expansion or real estate and equipment acquisitions. The bank provides a senior loan for 50 percent of the project cost, the federal government provides 40 percent of the project cost through a subordinate loan that is guaranteed by the SBA, and the small business borrower makes a 10 percent equity injection for the balance of the project cost. The senior bank loan as well as the subordinate SBA loan are bundled in separate pools and sold to investors, with many of the senior bank loans using private insurance to manage risk. Unfortunately, as you are well aware, private insurance failure has occurred, which has caused a total collapse of the secondary market for 504 loans and a drastic reduction in the number of loans available to small businesses.

Under the Troubled Assets Relief Program (TARP), we believe the Department of Treasury (Treasury) has existing authority to address illiquidity in both the 7(a) and the 504 secondary markets, and we urge you to exercise that authority immediately. By purchasing pooled SBA loans, originated by SBA lenders, the Treasury could provide much-needed liquidity in the secondary market for these loans. This would help to jumpstart SBA lending and free up liquidity for the hundreds of thousands of American small businesses that want to access loans in order to grow their businesses.

While the TARP was necessary to save our economy from a complete collapse, it has yet to reach the heart of America's economy: our small businesses. Small firms employ half of America's workforce and pump almost a trillion dollars into the economy each year. Main Street's owners require capital in order to continue to operate their businesses. They can not wait any longer for Wall Street's rescue to reach them. We, therefore, ask for your timely help, in providing this critical aid to the small business credit markets, by immediately purchasing 7(a) and 504 securities on the secondary market.

Should you have any questions or concerns, please do not hesitate to contact us directly. Your staff may contact Nick Coutsos with Senator Kerry's staff or Linda Le with Senator Snowe's staff at (202) 224-5175 on the Senate Committee on Small Business and Entrepreneurship. Thank you in advance for your prompt attention to these important issues.

Sincerely,

John F. Kerry
U.S. Senator

Olympia J. Snowe
U.S. Senator

Charles E. Schumer
U.S. Senator