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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–0315

MEMORANDUM

To:	Members, Subcommittee on Economic Growth, Tax, and Capital Access
From:	Andy Kim, Chairman
Date:	April 9, 2019
Re:	Subcommittee hearing: "SBA 7(a) Budget Proposal and the Impact of Fee Structure Changes"

The Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access will meet for a hearing titled, "SBA 7(a) Budget Proposal and the Impact of Fee Structure Changes." The hearing is scheduled to begin at **10:00 A.M. on Wednesday, April 10, 2019 in Room 2360 of the Rayburn House Office Building.** The hearing will allow Members to learn about the 7(a) Loan Guaranty Program and how it functions as one that usually operates at zero cost to the taxpayer. Further, the hearing will examine the Small Business Administration's (SBA) budget proposal for Fiscal Year 2020 (FY2020), the proposal contained therein to adjust the fee structures in the program, and the impact the proposed changes could have on the sustainability of the 7(a) program. The witnesses will be:

Panel 1:

- Mr. Tim Gribben, Chief Financial Officer & Associate Administrator for Performance Management, U.S. Small Business Administration, Washington, DC

Panel 2:

- Mr. Tony Wilkinson, President & CEO, National Association of Government Guaranteed Lenders, Stillwater, OK
- Ms. Lynn G. Ozer, President-SBA Lending, Fulton Bank, Pottstown, PA
- Ms. Gail Jansen, Vice President-Business Services & Operations, Kinecta Federal Credit Union, Manhattan Beach, CA
    - *Testifying on behalf of the National Association of Federally-Insured Credit Unions*
- Mr. Gordon Gray, Director of Fiscal Policy, American Action Forum, Washington, DC

Background and Program Overview

SBA administers programs to support small businesses, including loan guaranty programs designed to encourage lenders to offer loans to small businesses that may not be able to access affordable capital elsewhere on reasonable terms.[1] The 7(a) program is considered the agency's flagship loan program, and its name is derived from Section 7(a) of the Small Business Act, which

[1] Congressional Research Service, *Small Business Administration 7(a) Loan Guaranty Program*, R41146 (Mar. 4, 2019).

authorizes SBA to provide and guarantee commercial loans to U.S. small businesses.[2] Under this program, participating lenders offer commercial loans to eligible small businesses while SBA guarantees the loan in the event the borrower defaults, thereby minimizing the risk to the lender of making that loan. SBA guarantees from 50 to 90 percent of each 7(a) loan made, depending on the loan characteristics.[3] SBA also administers several subprograms within the 7(a) program that offer streamlined and expedited loan procedures for particular groups of borrowers, including the SBA Express, Export Express, and Community Advantage Pilot programs.[4] Although these subprograms have their own distinguishing eligibility requirements, terms, and benefits, they operate under the 7(a) program's authorization.[5]

SBA Guaranty and Servicing Fees

To offset the costs of issuing guarantees, SBA is authorized to charge lenders an up-front, one-time guaranty fee and an annual, ongoing service fee for each 7(a) loan approved and disbursed.[6] Fees vary depending on loan amount and loan maturity.[7] The maximum guaranty fee for 7(a) loans with maturities exceeding 12 months is set by statute and varies depending on the loan amount.[8] The fee is a percentage of the SBA's guaranteed portion of the loan.[9] On loans with maturities of less than 12 months (considered "short-term"), the lender must pay the guaranty fee within 10 days from the date the SBA loan number is assigned.[10] If the fee is not received within the specified time frame, SBA will cancel the guaranty.[11]

On loans with maturities greater than 12 months, the lender must pay the guaranty fee within 90 days of the date of loan approval.[12] For short-term loans, the lender may charge the guaranty fee to the borrower only after the lender has paid the guaranty fee.[13] For loans with maturities greater than 12 months, the lender may charge the guaranty fee to the borrower after initial disbursement.[14] Lenders are permitted to retain 25 percent of the guaranty fee on loans with a gross amount of $150,000 or less.[15] The annual service fee cannot exceed 0.55 percent of the outstanding balance of SBA's share of the loan and is required to be no more than the rate "necessary to reduce to zero the cost to the Administration of making guarantees."[16] The lender's annual service fee to SBA cannot be charged to the borrower.[17] In an effort to assist small business owners, SBA:

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[2] 15 U.S.C. § 636(a); *see also* Congressional Research Service, *Small Business Administration 7(a) Loan Guaranty Program*, R41146 (Mar. 4, 2019).

[3] U.S. Small Business Administration, *FY2020 Congressional Budget Justification and FY2018 Annual Performance Report* (2019).

[4] *Small Business Administration 7(a) Loan Guaranty Program*, *supra* note 1.

[5] *Id*.

[6] P.L. 93-386.

[7] Small Business Administration 7(a) Loan Guaranty Program, *supra* note 1.

[8] 15 U.S.C. § 636(a)(18)(A).

[9] Small Business Administration 7(a) Loan Guaranty Program, *supra* note 1.

[10] SBA SOP 50 10 5(K), p. 160 (2019).

[11] *Id*.

[12] *Id*.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] 15 U.S.C. § 636(a)(23)(A).

[17] 15 U.S.C. § 636(a)(23)(B).

- waived its annual service fee for all 7(a) loans of $150,000 or less approved from FY2014 through FY2016 (the annual service fee for other small businesses was 0.52 percent in FY2014, 0.519 percent in FY2015, and 0.473 percent in FY2016);[18]
- is waiving the annual service fee for 7(a) loans of $150,000 or less made to small businesses located in a rural area or a HUBZone in FY2019 (the annual service fee for other small businesses is 0.55 percent in FY2019);[19] and
- waived the up-front, one-time guaranty fee for all 7(a) loans of $150,00 or less approved from FY2014 through FY2017; waived the up-front, one-time guaranty fee for all 7(a) loans of $125,000 or less approved in FY2018; and is reducing the up-front, one-time guaranty fee for loans made to small businesses located in a rural area or HUBZone from 2 percent to 0.6667 percent of the guaranteed portion of the loan in FY2019.[20]

Current Issue - Federal Credit Reform Act of 1990 and appropriations for loan subsidy costs

SBA's Congressional Budget Justification for FY2020 predicts that without modifications to current law, it will not generate sufficient revenue from fees and collections of liquidated collateral to fully offset the cost of issuing guarantees in FY2020.[21] In response, SBA proposed a "counter-cyclical policy scenario," which includes numerous fee increases.[22] Prior to a discussion on fee structure changes and appropriations for loan subsidy costs, a working knowledge of how SBA and OMB project revenue under the Federal Credit Reform Act of 1990 (FCRA) is necessary.

Federal Credit Reform Act of 1990

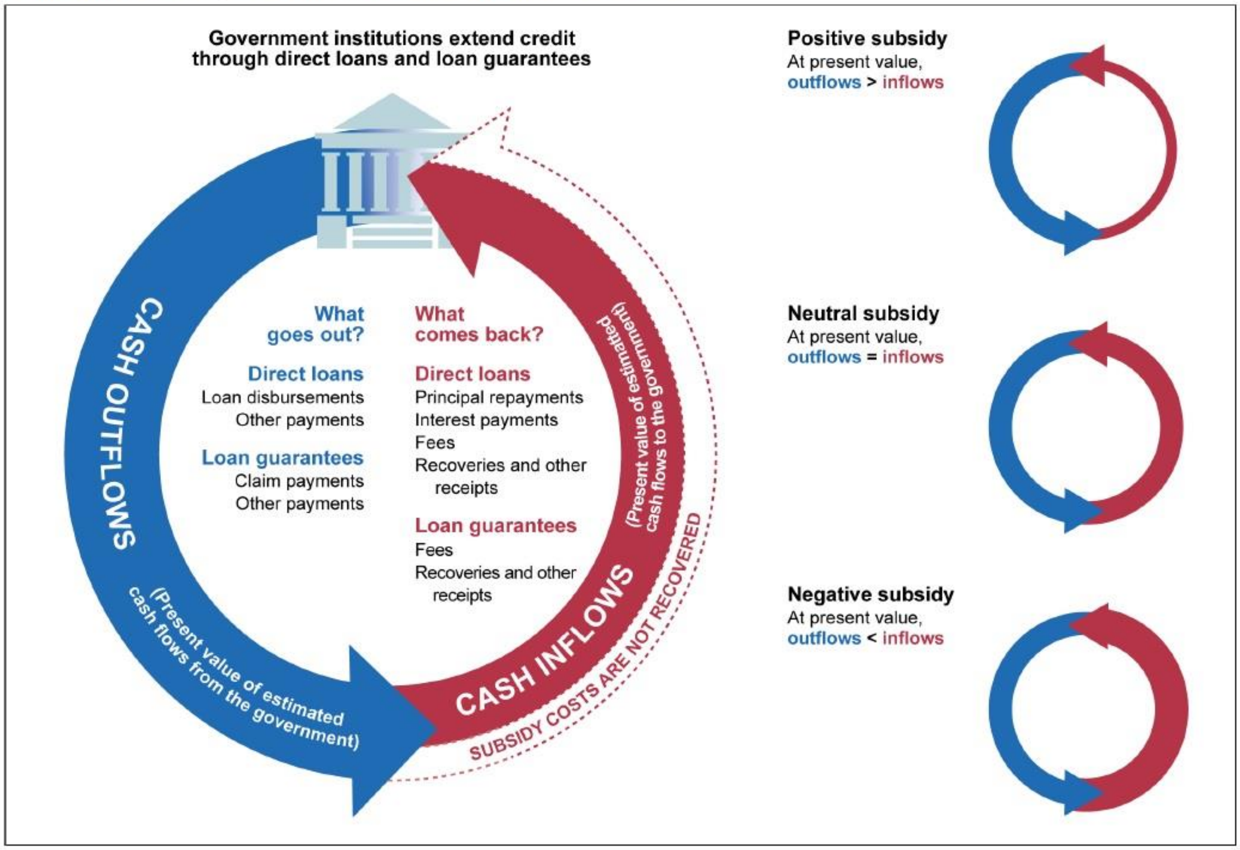
The enactment of FCRA changed the method used to budget the cost of federal credit programs, such as the 7(a) program.[23] FCRA was enacted with the intent of improving the accuracy of the cost of federal credit programs reported in the budget by requiring agencies to measure the government's net long-term cost of federal credit programs to permit better cost comparisons both among credit programs and between credit and noncredit programs.[24] The policies enacted under FCRA recognized that the actual cost of a direct loan or loan guarantee is not captured by its cash flows in any one year, but rather is the net present value—a measure that reflects the value of *all* future cash flows, both positive and negative, over the life of the loan. FCRA thus specified an approach using estimates of expected cash flows, including future loan repayments and defaults as elements of the cost to be recorded in the budget.[25]

FCRA requires agencies to estimate the net long-term cost to the government of extending or guaranteeing credit.[26] This cost, referred to as subsidy cost, equals the net present value of estimated cash flows from the government minus estimated cash flows to the government, over the life of the loan excluding administrative costs.[27] This approach puts direct loans and loan

[18] *Small Business Administration 7(a) Loan Guaranty Program*, *supra* note 1.
[19] *Id.*
[20] *Id.*
[21] U.S. Small Business Administration, *supra* note 3.
[22] *Id.*
[23] U.S. Government Accountability Office, *Credit Programs: Key Agencies Should Better Document Procedures for Estimating Subsidy Costs*, GAO-16-269 (July 2016).
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*

guarantees on equal footing in terms of cost in the federal budget and permits the costs of credit programs to be compared with each other and with the costs of noncredit programs.[28]

Calculation of Subsidy Costs for Direct Loans and Loan Guarantees



Source: GAO-16-269.

The subsidy cost represents the net present value cost of making or guaranteeing new loans and is included in the President's Budget for the year the direct loan or loan guarantee is made.[29] FCRA requires that agencies have budget authority to cover a program's subsidy cost to the government in advance – before new direct loan obligations are incurred and new loan guarantee commitments are made.[30]

The data used for budgetary subsidy cost estimates are generally updated—or reestimated—annually after the end of the fiscal year to reflect actual loan performance and to incorporate any changes in assumptions about future loan performance.[31] Reestimates that increase subsidy costs are referred to as upward reestimate (an agency would need additional funds), while reestimates that decrease subsidy costs are referred to as downward reestimates (an agency would return

[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*

funds).[32] Agencies do not need to request additional appropriations to cover upward reestimates because FCRA provides permanent indefinite budget authority for this purpose.[33]

FCRA Modeling

To implement FCRA and calculate subsidy costs, agencies estimate the expected cash outflows and inflows over the life of the loans for each cohort of direct loans obligated or loan guarantees committed in the cohort year.[34] The efforts to make reasonable subsidy cost estimates begin with establishing and using reliable records of historical credit performance data and taking into consideration current and forecasted economic conditions.[35] Agency management is responsible for accumulating relevant, sufficient, and reliable data on which to base the estimates.[36] Further, subsidy cost estimates should be based on a systematic methodology to project expected cash flows into the future.[37]

Accomplishing this task requires an agency to develop a cash flow model using historical information and various assumptions related to future loan performance, including factors like loan repayments, prepayments, defaults, recoveries, and the timing of these events.[38] The model helps identify elements that affect loan performance.[39] In addition to using historical data, other factors may include:

- economic conditions that may affect loan performance;
- financial and other characteristics of borrowers;
- the value of the collateral to the loan balance;
- changes in recoverable value of collateral; and
- newly developed events that would affect loan performance.[40]

Documentation

Various budgeting and accounting guidance related to estimating subsidy costs requires agencies to establish internal controls over calculations, including establishing and documenting policies and procedures and maintaining supporting documentation for subsidy cost estimates.[41] In 2004, GAO published a report reviewing SBA's estimation methodology and equations while assessing the default and recovery rates the model produced.[42] GAO found that from an economics perspective, SBA's econometric equations were reasonable, and that its model produced estimated default and recovery rates that were in line with historical experience.[43] However, from an audit perspective, SBA's lack of documentation of the model development process precluded GAO and others from independently evaluating the model's development and determining if SBA used a

[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*

sound and consistently applied method to select and reject model variables.[44] Specifically, GAO and two other independent reviewers could not determine whether a bias existed in the model by systematically excluding variables to influence the subsidy rate in a particular direction.[45] These historic concerns with lack of documentation have raised questions about the economic assumptions and other inputs used in calculating the subsidy rate for FY2020, especially given the relative strong performance of the 7(a) portfolio over the previous six years and the strong economic outlook in the President's budget.[46]

SBA's FY20 Budget

Traditionally, one of SBA's goals is to achieve a zero-subsidy rate for its loan guaranty programs, including the 7(a) program.[47] This occurs when the loan guaranty programs generate sufficient revenue through fee collections and recoveries of collateral on defaulted loans so as to not require appropriations from Congress to issue new guarantees.[48] Excluding the period from 2010-2013 – when the nation was recovering from the Great Recession – SBA has operated at zero-subsidy since 2005.[49]

However, in its Congressional Budget Justification for FY2020, SBA predicts that without modifications to current law, it cannot achieve a zero-subsidy rate for the 7(a) program in FY2020.[50] This means the 7(a) program is not predicted to generate sufficient revenue through fee collections and/or recoveries of collateral on defaulted loans. In response, SBA proposed numerous fee increases.[51] Specifically, SBA is seeking authority to change the fee structure in the 7(a) program to: 1) cover the anticipated subsidy in the program of $99 million (due to changes in SBA's economic modeling and assumptions at the Office of Management and Budget (OMB)); and 2) extract an additional $93 million to cover the administrative costs of the 7(a) program.[52] Specifically, the proposed counter-cyclical scenario includes a 0.5 percent increase of the up-front fee on loans between $500,001 to $700,000, a 0.5 percent increase of the up-front fee on loans over $1.5 million, a 0.25 percent increase of the up-front fee on loans with a term of less than one year, and an increase of the annual fee to 0.83 percent on loans of more than $1.5 million.[53]

Concerns have been raised regarding how the modifications[54] to SBA's economic modeling and OMB's economic assumptions are leading to a bleak outlook for FY20 program performance. At this time, it is unclear what factors are going into the model and the weight each of them carries as it relates to calculating the model. For instance, the 7(a) program's recovery amount on defaulted loans as a percentage of the purchase amount was at 50 percent as of June 2018.[55] In

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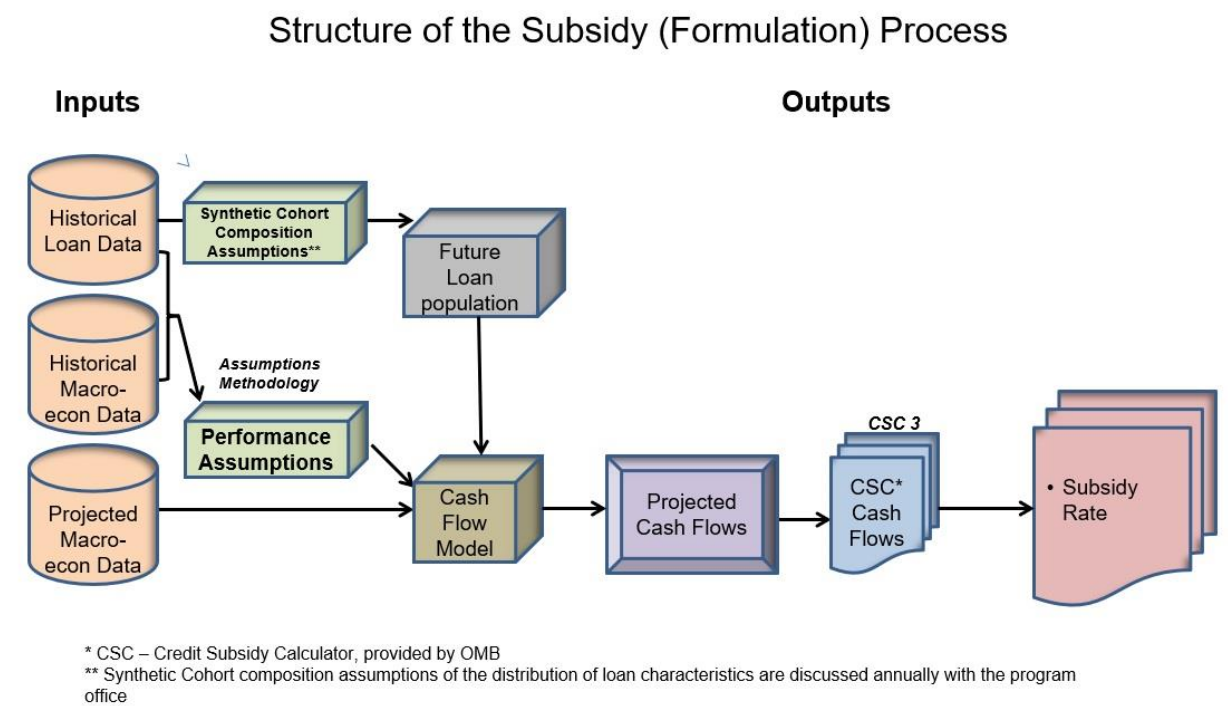
[44] *Id.*
[45] *Id.*
[46] U.S. Small Business Administration, Loan Program Performance Table 9, available at https://www.sba.gov/sites/default/files/aboutsbaarticle/Final_Website_Reports_Q4_FY18_1.zip.
[47] *Small Business Administration 7(a) Loan Guaranty Program*, *supra* note 1
[48] *Id.*
[49] *Id.*
[50] U.S. Small Business Administration, *supra* note 3.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] U.S. Small Business Administration, *7(a) portfolio five year net cash flows*, (2019).

contrast, the FY2020 budget assumes a projected recovery rate of 37.29 percent.[56] It is currently unclear why SBA and OMB disregarded the stronger performance metric in calculating the subsidy rate. These assumptions and data are critical to predicting whether the 7(a) program will operate at a zero-subsidy, negative-subsidy, or positive-subsidy rate, which in turn is used by SBA to formulate its budget request, and specifically, to determine whether it needs to request appropriations from Congress to subsidize the cost of guaranteeing 7(a) loans. Below is a diagram showing the process by which SBA and OMB calculate the subsidy rate.



Source: SBA, Fundamentals of Credit Modeling.

Impact on Small Business Access to Capital

There are concerns this proposal can ultimately put considerable downward pressure on access to capital for small businesses. By design, the 7(a) program is intended to reach small businesses and entrepreneurs left behind by the conventional lending markets. By proposing to raise fees, SBA is only making that affordable capital more difficult to access. Not only will small business borrowers potentially be forced to pay higher fees as part of taking out a 7(a) loan, but 7(a) lenders may also withdraw from the program, further reducing its effectiveness. Specifically, there is a concern that credit unions located in large cities, who tend to have lower average loan sizes and whose small business clients tend to face higher real estate costs, will be particularly harmed by the proposed fee increases. There are also concerns that such a proposal will force would-be 7(a) borrowers into riskier, more dangerous lending products.

[56] U.S. Office of Management and Budget, *Fiscal Year 2020 Budget of the U.S. Government – Federal Credit Supplement*, Table 6 (2019).

Conclusion

SBA's 7(a) program is the economy's main vehicle for entrepreneurs to access affordable capital on reasonable and fair terms. It is also an engine of job creation, responsible for supporting over 540,000 jobs in FY2018.[57] Therefore, preserving the integrity of the 7(a) program is a top priority of the Committee, and any proposals that threaten that integrity will be reviewed with the highest degree of scrutiny. Accordingly, this hearing will offer Members the opportunity to learn more about how the 7(a) program functions as one that usually operates at zero cost to the taxpayer. Specifically, Members will be able to ask witnesses about the changes to the estimated subsidy rate for FY2020 and the potential impact SBA's counter-cyclical fee proposal would have on access to capital for small businesses.

[57] U.S. Small Business Administration, *supra* note 3.