



Testimony

SBA 7(a) Budget Proposal and the Impact of Fee Structure Changes

GORDON GRAY | APRIL 10, 2019

The opinions expressed herein are mine alone and do not represent the position of the American Action Forum.

Introduction

Chairman Kim, Ranking Member Hern and members of the Committee, I am honored to be before you today to discuss the budgetary considerations of the Small Business Administration's (SBA) 7(a) loan program. This is an important program that provides access to small business entrepreneurs who otherwise have no access to adequate financing and supports hundreds of thousands of jobs. As a taxpayer-funded program, it should be subject to continuous and rigorous oversight, and I appreciate the Committee's attention to this program in today's hearing.

In my testimony, I wish to make three basic observations:

- The federal government is a prolific lender, providing guarantees on and direct loans of \$4 trillion as of fiscal year (FY) 2018.
- The budgetary treatment of credit programs is somewhat unique in budgeting, adhering to the principles of accrual accounting as set forth in the Federal Credit Reform Act (FCRA) of 1990.
- FCRA accounting addresses the deficiencies of cash accounting in measuring the cost of credit programs, but necessarily introduces additional complications.

Let me discuss these in turn.

Federal Credit Assistance

The federal government is a prolific lender, providing a combined \$4 trillion in credit assistance as of FY2018 to American households and businesses.^[1] In general, the goal of this assistance is to provide credit to borrowers, who otherwise would not receive credit at market terms from lenders.

The nature of this credit assistance is varied across federal agencies and activities, but generally takes two forms: direct loans and guaranteed loans. The Office of Management and Budget (OMB) defines direct loans in circular A-11, the executive branch's primary set of guidelines for budget preparation and execution as: "a disbursement of funds by the Government to a non-Federal borrower under a contract that requires the repayment of such funds with or without interest. The term also includes certain equivalent transactions that extend credit."^[2] Essentially, for direct loan programs, the federal government assumes the role of the lender – underwriting and issuing loans to recipients on terms that are generally more favorable than those provided by the market. These preferential terms can take the form of below-market interest rates, repayment grace periods, interest-only periods, and other features that are designed to provide eligible borrowers with greater access to credit than would otherwise be available. As of FY2018, the federal government has \$1.4 trillion in direct loans outstanding.

The federal government also provides substantial credit assistance in the form of loan guarantees. OMB defines loan guarantees as: "any guarantee, insurance, or other pledge with respect to the payment of all or a part of the principal or interest on any debt obligation of a non-Federal borrower to a non-Federal lender. The term does not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions." In these instances, a financial institution is responsible for underwriting (subject to program guidelines) and issuing loans to eligible individuals and institutions. Repayment of those loans is made directly to the lender, but the government typically receives compensating fee payments as a condition of the guarantee. If the borrower defaults on the loan, however, the federal government is liable for the amount of the loan that it guaranteed, which is typically a percentage of the overall loan amount. As of FY2018, the federal government had extended guarantees to \$2.6 trillion in loans outstanding.

It is this form of credit assistance that concerns today's hearing: the 7(a) loan program. The 7(a) program provides eligible small businesses with private-sector financing with a public guarantee. The program includes several specialized features, but in general provides up to a 75 percent guarantee on loans up to \$5 million. The program requires lenders to ensure borrowers demonstrate adequate ability to repay, management ability and equity, among other considerations. Credit is also contingent on borrowers demonstrating that credit is otherwise unavailable at reasonable terms. According to the SBA, the 7(a) loan program supported over 60,000 loans totaling \$25.4 billion in FY2018.^[3]

The Budgetary Treatment of Credit Programs

Prior to 1992, federal credit assistance programs were recorded for budgetary purposes on a cash basis like any other federal spending program. For any credit program, this presents a distorted view of the program's effects. In the most simplistic terms, a loan is a lump payment to a borrower in exchange for future payments. On a cash basis, this would look like a large outlay in the year of the loan's origination, and assuming the life of the loan is longer than the budget window, an insufficient funding stream. Loan guarantees present more difficulties still. The defining feature of a loan guarantee is that it is a contingency only recognized upon realization. Which is to say, at origination, a federal loan guarantee commitment would not record any budgetary flows on a cash basis (except perhaps any fees collected). Cash accounting simply does not capture the commitment of taxpayer funds that is the basis for the value of the federal guarantee. This budgetary treatment also confounded oversight of program performance.

The Federal Credit Reform Act changed the budgetary treatment of these credit programs beginning in 1992.^[4] The Act required that new federal credit commitments (among other budgetary flows) be recorded on an accrual basis going forward. Under the new methodology, the net present value of the taxpayer subsidy would be recorded in the year of the new commitment. Accrual accounting has the advantage of capturing all cash flows associated with a given credit program and accounts for the effect of the timing of those payments through discounting. FCRA requires the use of Treasury yields for discounting future cash flows under FCRA.^[5]

Accrual accounting more accurately captures the taxpayer exposure for a given credit program by recognizing the value of the upfront outlay by the taxpayer, but also the associated repayment stream even if it is outside the budget window. This treatment also captures the value of preferential credit terms, such as longer loan maturities or interest deferral.

The Anatomy of a Subsidy Rate

The net present value of cash flows associated with a given loan cohort represents the cost of the credit subsidy. It is this subsidy cost for which Congress provides funding. For example, according to the SBA, new 7(a) loans in FY2020 are projected to incur a positive subsidy cost, which must either be offset through an appropriation, fee changes, or other terms that would reduce taxpayer exposure. According to the SBA, the program is projected to have a 33 basis point subsidy cost on \$30 billion in loans, requiring a \$99 million congressional appropriation to support the additional lending in FY2020. SBA reports this is due to, "refinement of the model to increase precision for estimating purchase amounts and sensitivities

of the model related to long term macroeconomic assumption.”[6]

As noted above, prior to the enactment of FCRA, the basic unit of measurement of the budgetary effects of a credit program was the annual cash flow. Under FCRA, the basic unit of measurement is the subsidy cost, which is the net present value of all future cash inflows and outflows, discounted at term-matched Treasury rates, for a cohort of loans. These flows include the net effects of defaults, fees, and recoveries. It does *not* include administrative or incidental effects to other federal budgetary flows.

To illustrate how these values are calculated, consider the following examples developed by the Congressional Budget Office.[7] Assume the federal government provides \$100 in credit assistance to the public. Also assume that the Treasury rate over the term of the loan is 5 percent. At 5 percent, the cost of repayment would be \$105. Discounted at the same rate, the \$105 in future payments equals the face value of the loan. This example assumes no fees or other associated flows. Now consider a cohort of loans with a 25 percent default rate. For simplicity, assume that borrowers have no assets to recover. Under this scenario, the federal government would collect \$78.75 in cash repayments, which are worth \$75 in present value. The program thus has a \$25 subsidy cost. If Congress were to enact this program, it would need to provide \$25 in budget authority to fund this credit assistance. Note that if the federal government merely guaranteed these loans rather than originated them, it would face the same subsidy cost, assuming the government guaranteed 100 percent of the loan. The subsidy *rate* for this program is expressed as the subsidy cost over the disbursement of the loan, which in this case is 25 percent. Additional flows would further affect this rate, such as recoveries and fees.

It is important to recognize that this calculation more accurately reflects the totality of the federal commitment for a given credit program. It also necessarily introduces additional complications, however. By nature, FCRA requires projecting all associated cash flows for a given loan over its duration. This also requires projecting likely delinquencies, defaults, prepayments, interest rates, and other factors to determine credit subsidy rates. The subsidy cost is thus exposed to fluctuations for any of these factors.

Underpinning a number of these elements is OMB’s economic assumptions, which the agencies are required to use as part of this calculation. The strength of the economy substantially effects default rates for example, and a worsening economic outlook, would all else equal, increase the subsidy cost to the federal government through higher defaults among other considerations.

The federal government annually reestimates subsidy rates for credit programs. These reestimates are presented in a supplement to the president’s budget and provide a crosswalk from the original estimate to the current estimate, detailing which of the major elements of the subsidy rate changed. These elements include changes to interest rates as well as technical assumptions, which includes delinquencies, defaults, and other performance factors. Note that under FCRA, increased reestimated costs are funded in the following year by permanent

indefinite budget authority, while decreased costs are returned by the agencies to the general fund. Thus, there is no legislative consequence for underestimating the cost of a loan cohort. For example, the subsidy cost for loan guarantees issued under the SBA 7(a) program have on net been reestimated upwards by about \$1.7 billion (excluding interest) since 1992, but Congress did not have to enact additional funding into law.[8] Not surprisingly, the largest upward reestimates occurred for loans issued immediately before during and after the Great Recession. Note, however, that this reestimate covers guarantees on over \$292.9 billion in loans disbursed under the program.

Conclusion

The Small Business Administration's 7(a) loan program is critical to providing entrepreneurs with access to credit, supporting over 60,000 borrowers with over \$25 billion in guaranteed loans last year. As a credit program, however, accurately measuring the taxpayer exposure to risk is somewhat more complicated than is estimating the cost of typical federal spending programs. The current standard, FCRA, represents an important reform that improved the measurement of these risks over the cash-accounting method that prevailed until 1992. The new method records subsidy costs that reflect the performance of the loan over its full term. This approach necessarily requires projecting the associated cash flows of that loan over time. Any time a measurement requires projecting into the future, some uncertainty however is introduced. Since FCRA was enacted, the subsidy costs of the 7(a) programs have been underestimated, with net positive lifetime reestimated subsidy costs. Yet these costs are quite small over nearly three decades and relative to the overall size of loan disbursements. It does appear, however, that this net underestimate is driven largely by the effects of the economic downturns.

[1] https://www.whitehouse.gov/wp-content/uploads/2019/03/ap_22_credit-fy2020.pdf

[2] <https://www.whitehouse.gov/wp-content/uploads/2018/06/a11.pdf>

[3] https://www.sba.gov/sites/default/files/aboutsbaarticle/2018_SBA_PAR_FINAL_1218_508.pdf

[4] P.L. 101-508; The 1997 Balanced Budget Act made several technical changes to FCRA generally designed to improve the uniformity and consistency of estimates of the costs of credit programs:

<https://www.govinfo.gov/content/pkg/BUDGET-1999-PER/pdf/BUDGET-1999-PER.pdf>

[5] There is a robust debate among policy observers as to whether a discount rate that incorporate market risk would be a more accurate measure of the cost to tax payers, known as fair-value accounting. This discussion, however, is outside the scope of my testimony.

[6] https://www.sba.gov/sites/default/files/2019-03/SBA%20FY%202020%20Congressional%20Justification_V2_15Mar19_508Statement_0.pdf

[7] <https://www.cbo.gov/sites/default/files/108th-congress-2003-2004/reports/08-19-creditsubsidies.pdf>

[8] <https://www.govinfo.gov/content/pkg/BUDGET-2020-FCS/pdf/BUDGET-2020-FCS.pdf>