

GAO

Testimony

Before the Committee on Small Business, House of
Representatives

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**SMALL BUSINESS
ADMINISTRATION**

**Credit Subsidy Estimates
for the Sections 7(a) and
504 Business Loan
Programs**

Statement of Judy A. England-Joseph,
Director, Housing and Community
Development Issues,
Resources, Community, and Economic
Development Division



Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our review of the Small Business Administration's (SBA) estimates of credit subsidies for the agency's guaranteed business loan and certified development company programs—more commonly called the “7(a)” and “504” programs, respectively. As you know, the credit subsidy for these programs is the estimated net cost (excluding administrative costs) to SBA in today's dollars of guaranteeing these loans over the entire time period in which the loans are outstanding, which can range up to about 25 years. The Federal Credit Reform Act of 1990 requires that SBA estimate these costs for loans guaranteed after fiscal year 1991 so that they can be included in the federal budget in the year in which the loan commitments are made. These estimates, and any subsequent re-estimates, identify for the Congress the amount of appropriations needed to cover the government's expected costs over the lives of the loans. In the President's budget for fiscal year 1997, SBA estimated that the costs of 7(a) and 504 program loans to be made in fiscal year 1997 would be significantly higher than the costs of loans made in fiscal year 1996, despite legislated program changes designed to keep costs down.

Our statement today is based on our review of SBA's estimates of credit subsidies for the 7(a) and 504 programs that you requested in April of this year as well as our ongoing work on such estimates in the major credit agencies throughout the federal government. As requested, this statement focuses on three questions: (1) How does SBA calculate the estimates of credit subsidies for the 7(a) and 504 programs? (2) What factors accounted for the increases in the estimated costs of the loans to be guaranteed by these programs in fiscal year 1997? (3) What additional changes, if any, did SBA make during the 1998 budget process when estimating the costs of its loans? As agreed with your office, we did not assess the reliability of the automated data on individual loans that SBA uses to generate its credit subsidy estimates.

In summary, we found the following:

- SBA bases its estimate of the credit subsidy for each program on projections of cash flows—that is, the amounts of cash that SBA expects to take in and pay out during each year that the loans are outstanding. Cash outflows occur when borrowers default on their loans and SBA pays claims filed by lenders. Cash inflows occur when the collateral for defaulted loans is liquidated and when borrowers and lenders pay mandatory fees to

SBA. These cash flow projections are based largely on the historical performance of the programs' loans; however, SBA adjusts the projections to reflect the estimated influence of changes in the programs' provisions and other factors. The cash flows are discounted to determine their net present value using a computer model established and maintained by the Office of Management and Budget (OMB).¹

- The factors contributing to the increases in the estimated credit subsidy rates for fiscal years 1997 differed somewhat between the two programs. For the 7(a) program, SBA projected fewer recoveries (the amounts realized when defaulted loans are liquidated) and less revenue from fees than it had assumed in previous years. These changes, which accounted for about 60 percent of the increase, resulted primarily from SBA's use of a new database on historical loan performance that expanded and improved on existing data, according to SBA and OMB officials. In addition, an error in applying SBA's cash flow projections to OMB's discounting model caused the estimated credit subsidy rate for the 7(a) program to be even larger. This error accounts for the remainder of the increase. On the basis of its appropriated budget authority of \$198.5 million, SBA announced that it could guarantee an additional \$2.47 billion in 7(a) loans because the credit subsidy rate estimate should have been lower. For the 504 program, SBA projected both more claims and fewer recoveries for defaulted loans than it had assumed previously. As in the 7(a) program, these changes—which account for all of the increase—resulted from SBA's use of a more extensive historical database.
- For the fiscal year 1998 budget request, SBA further revised its projections of cash inflows and outflows for the two programs. For 7(a) loans, SBA decreased its estimate of expected fee revenue, on the basis of data on loans that are paid off prior to maturity, or "prepaid." Because SBA would have to cover more of the cost of loan defaults if revenues from fees are less than originally expected, this change had an upward effect on the subsidy rate estimate for the 7(a) program. For the 504 program, SBA increased the estimated prepayments and slightly reduced expected claim payments and recoveries. With these changes and a fee increase, SBA estimated a credit subsidy rate of zero for new 504 loans.

Background

The 7(a) and 504 programs are two of SBA's primary programs for enhancing small businesses' access to credit. Under the 7(a) program, SBA guarantees up to 80 percent of the amounts of loans made by private lenders to small businesses that are unable to obtain financing under

¹Present value is the value today of a stream of payments in the future. In calculating the present value of loan subsidy costs, prevailing interest rates for U.S. Treasury securities provide the basis for converting future amounts into current dollar equivalents.

reasonable terms and conditions through normal business channels. In fiscal year 1996, SBA guaranteed about \$7.3 billion in small business loans through the 7(a) program. SBA's guarantee transfers the major risk of default from the lenders to SBA. When a loan guaranteed through the 7(a) program defaults, SBA pays the lender's claim by purchasing the guaranteed portion of the unpaid balance of the loan.² SBA then recovers as much of the claim amount as it can through the liquidation of the small business' collateral.³ In return for its guarantee, SBA collects fees from 7(a) lenders. SBA collects three types of fees for 7(a) loans: (1) an upfront fee which lenders may collect from borrowers, (2) an annual fee charged to lenders, and (3) a fee charged to lenders for certain 7(a) loans they sell through the secondary market.⁴ According to SBA, about half of the 7(a) loans made each year are sold through the secondary market.

Like the 7(a) program, the 504 program uses SBA guarantees to assist small businesses. Under this program, SBA provides its guarantee through certified development companies (CDC)—private, nonprofit corporations. CDCs may sell debentures that are fully guaranteed by SBA to private investors and lend the proceeds to qualified small businesses for acquiring real estate, machinery, and equipment and for building or improving facilities.⁵ These debentures funded about \$2.4 billion in loans during fiscal year 1996. If a small business defaults on its loan from the CDC, SBA pays a claim filed through a central servicing agent, thereby ensuring that investors receive full and timely payments. SBA recovers some of the claim amount through the liquidation of the small business' collateral. However, projects financed with 504 loans typically involve a supplemental mortgage from a private-sector lender who has a first lien on the collateral. In return for guaranteeing 504 program debentures, SBA charges both upfront and annual fees.

To help lower the federal cost of these programs, in October 1995 the Congress enacted the Small Business Lending Enhancement Act of 1995 (P.L. 104-36). Among other things, the act (1) lowered the maximum guaranteed portion of most 7(a) loans from 90 to 80 percent, (2) created the annual fee charged to lenders and increased the upfront fee for 7(a) loans, and (3) created the annual fee for the 504 program. The latter fee

²The lender's claim can include up to 120 days of accrued interest.

³Collateral may be liquidated by either SBA or lenders. Liquidation is the process of converting assets to cash.

⁴Lenders may sell the guaranteed portion of 7(a) loans to investors. These investors are referred to as the "secondary market" for the loans.

⁵A debenture is an investment typically backed by the integrity of the borrower (but in this case, by SBA) and documented by an agreement called an indenture.

was increased on September 30, 1996 by the Small Business Programs Improvement Act (P.L. 104-208).

We obtained information on how SBA's credit subsidy estimates are prepared primarily by interviewing officials from SBA and OMB. We identified the factors accounting for the changes in the estimates primarily by reviewing the automated cash flow spreadsheets underlying these estimates. However, we did not verify the accuracy of the loan performance data used in the spreadsheets. We also obtained information through interviews with officials from the Congressional Budget Office and the two major industry associations for the 7(a) and 504 programs.

How Credit Subsidy Estimates Are Currently Calculated

For the 7(a) and 504 programs, SBA bases the estimates of credit subsidies for the loans guaranteed during a given year on projections of the cash inflows and outflows likely to result from the loans.⁶ To project future cash flows, SBA first reviews available data on the cash flows it has experienced with loans made in the past. SBA then estimates cash flows for future "outyears"—the later years of the loans' lives for which there are not yet any historical data—and adjusts for recent program changes that are expected to affect the cash flows. As part of the annual budget process, SBA prepares these cash flow projections for loans to be made during the budget year. An automated discounting model developed and maintained by OMB and distributed to federal agencies converts the cash flows prepared for all federal credit programs into the credit subsidy rate estimates and budget authority requests that are presented in the President's budget. The estimated credit subsidy rates for SBA's 7(a) and 504 programs are expressed as a percentage of the total amount of loans or debentures to be disbursed.

Performance of Loans Made in the Past Is a Key Factor in Projecting Future Claims and Recoveries

For each program, SBA bases the projected claim payments and recoveries for defaulted loans largely on the performance of the loans made in the past. According to SBA and OMB officials, SBA uses data on the performance of the loans made through the 7(a) and 504 programs since 1986.

SBA analyzes data on the portion of the loans made in each past year that has defaulted and the amounts it has recovered since the loans were made. SBA uses these data to compute an average claim rate and recovery rate for each year in a loan's life. For example, the average claim rate for 504 loans in their first year is the average of the actual rates observed in the first

⁶Neither program includes an interest rate subsidy.

years of past loans; the average claim rate for 504 loans in their second year is the average of the actual rates observed in the second years of past loans; and so on. Unless SBA expects recent program changes to affect future defaults, these cash flows of average historical data are SBA's estimates of claims and recoveries for new loans. In this way, SBA's method of projecting claims and recoveries for new loans gives equal weight to the performance of loans made in the past, regardless of differences in the volume of loans made during each year or their ages.

In addition, for 7(a) loans, SBA considers differentials in loan performance by the type of the loan. Specifically, SBA calculates average claims and recoveries, on the basis of actual historical data, for the various categories of (1) the maturity of the loan, (2) the size of the loan, (3) the type of lender,⁷ and (4) the percentage of the loan guaranteed by SBA. SBA then uses these data to calculate an overall average claim rate and recovery rate for the new loans. SBA does not conduct an analysis of loan type for the 504 program because the program is smaller and because there is less variation in types of loans than in the 7(a) program.

SBA uses the actual historical averages as a basis for the expected claims and recoveries during the first 11 years of the new loans' lives.⁸ For the later years of the new loans' lives—the "outyears"—SBA projects claims and recoveries through several methods. For 7(a) loans, SBA projects claims through the 16th year after the loans are made and projects recoveries through the 18th year. For the 12th and 13th years of the loans' lives, SBA projects claims and recoveries by assuming a continuation of the trend demonstrated by the historical data for the first 11 years and by considering data on the performance during the 12th and 13th years of loans made prior to 1986. For later years, SBA roughly estimates additional claims and recoveries by considering the trend in the data for the first 13 years and by assuming that there will be at least some claims and recoveries during each of these later years. SBA does not project claims and recoveries beyond the 18th year because of the uncertainty of these estimates and because the figures are likely to be very small, according to

⁷SBA's analysis by type of lender considers whether loans are made by preferred lenders, certified lenders, or other lenders. Preferred and certified lenders receive full or partial delegation of authority to approve loans.

⁸SBA may also add outyear estimates to the historical data for each past year of loans before the data are averaged. This procedure ensures that there are 11 years of performance data linked directly to actual data for each past year of loans, even for loans made less than 11 years ago. SBA adds these outyear estimates by assuming the same trends in claims and recoveries demonstrated by data for older loans.

SBA officials. Although the maximum maturity for 7(a) loans is 25 years, the average maturity is about 12 years, according to OMB officials.

For 504 loans, SBA projects claims through the 16th year and recoveries through the 22nd year. For years after the 11th, SBA roughly estimates additional claims and recoveries by considering the trend in the historical data for the first 11 years and by assuming that there will be at least some claims and recoveries during each of these later years. Although the maximum maturity for a 504 loan is 20 years, the average maturity is 19 years, according to OMB officials. SBA estimates cash flows for outyears so that the estimated credit subsidy rate represents the expected federal cost of all of the loans made during a year over their entire lives, not just the years for which historical data are available.

Current Rates and Historical Data Are Used to Project Future Fee Revenues

For both the 7(a) and 504 programs, SBA bases its projections of revenues from fees primarily on the fee rates in effect at the time that program loans are made and on the estimates, based on historical data, of annual outstanding loan balances.

For the 7(a) program, SBA projects revenues for each of the three types of fees, as follows:

- The upfront fee is based on the original dollar amount of the guaranteed portion of the loan. Because the fees vary according to the size of the guaranteed portion, SBA calculates an average rate for upfront fees by estimating the percentage of the new loans in each category of loan size.⁹ SBA's projection of the cash flow from upfront fees is also based on the collection of the upfront fee over the first two years of the loans' lives, rather than the entire amount in the first year, because not all loans are disbursed during the first year.
- Annual fee revenue is based on estimated outstanding loan balances at the end of each year of the life of the loans. SBA bases its estimates of outstanding balances on historical data on the portion of balances amortized each year and then subtracts the amount that it expects to pay in claims and the amount of loans that it estimates will be prepaid. SBA does not maintain data showing when 7(a) loans are prepaid. Instead, the agency estimates prepayment rates and trends on the basis of the historical prepayment data that it obtains for those 7(a) loans that are sold

⁹This average also reflects the small number of 7(a) loans with maturities of less than one year. These loans are charged a fee rate that does not vary with the size of the guaranteed portion. SBA estimates that about one percent of all loans made each year have maturities of less than one year.

through the secondary market.¹⁰ In this way, the actual data on prepayments and claims for prior year loans helps SBA estimate how much the outstanding principal balance on new loans will decline over the life of the loans and thus how much it is likely to collect in revenues from the annual fee.

- Similarly, SBA estimates the amount of secondary market fee revenues it will collect by looking at historical data on loans sold through the secondary market.

For the 504 program, projecting the cash flows from fees is slightly less complicated because the upfront fee does not vary with the size of the loan and there is no secondary market fee. SBA's projection of upfront fees is based on the rate in effect when the loans are made and the collection of the fee during the first few years of the loans' lives because not all loans are disbursed during the first year. Like the 7(a) program, annual fee revenues are based on the estimates of outstanding loan balances at the end of each year during the life of the new loans. SBA bases its estimates of outstanding balances on historical data on the portion of balances amortized each year and then subtracts the amount of loans it expects to default and the amount of loans that it estimates will be prepaid. SBA maintains its own data on prepayments in the 504 program because of the program's prepayment penalty.

SBA Adjusts Cash Flows to Reflect Changes in the Programs

Before converting the projected cash flows into an estimated credit subsidy rate, SBA may adjust them to reflect any recent program changes that are expected to reduce or increase future claim payments or recoveries. For example, SBA adjusted its projected recoveries for loans made through the 504 program in 1998 to reflect the impact of the agency's Liquidation Improvement Project—an effort designed to increase the portion of SBA's claim payments for defaulted loans that it recovers through the liquidation of collateral.

Officials from SBA, OMB, and the two primary industry associations for the 7(a) and 504 programs have suggested several alternative methods SBA could use to estimate future claims and recoveries. For example, SBA could develop an econometric model which uses regression analyses to predict future claims and recoveries based on factors such as forecasted interest rates, economic growth, lender type, and loan size. According to a government-wide task force, econometric modeling is the best way to use

¹⁰According to SBA, the guaranteed portion of about half of the loans made through the 7(a) program each year are sold through the secondary market. We did not determine whether these loans are representative of all 7(a) loans made each year.

historical data to estimate credit subsidies.¹¹ Similarly, we have used econometric models to forecast future loan performance in programs operated by the Department of Veterans Affairs and the Department of Housing and Urban Development due to their superior predictive capabilities.¹² While we believe that, over time, such analysis of loan performance data may yield better estimates, we have not reviewed the merits of any particular approach for SBA's programs.

OMB's Model Generates Estimates of the Credit Subsidy Rate

To generate an estimate of the credit subsidy rate, SBA's cash flow projections for claims, recoveries, and fees assuming a certain amount of business are run through OMB's automated discounting model. This model produces an estimate of the credit subsidy rate representing the net present value of the federal costs expected per dollar loaned through the program. This estimate is used to determine the amount of appropriations necessary to cover the long-term costs of a given amount of loans.

During the preparation of each year's budget submission, OMB examiners typically work with SBA to refine its cash flow projections and subsidy estimates. OMB may question the basis for SBA's projected cash flows and/or request an alternative set of cash flows based on different assumptions. For example, during the past few years, SBA has expressed interest in limiting the historical data used as a basis for projected cash flows to loans made since 1989. According to SBA officials, recently guaranteed loans are better predictors of future loan performance because they reflect the changes made to strengthen SBA's programs during the 1990s. On the other hand, OMB officials stated that the performance of loans in the 1980s should be considered because these years include an economic downturn, which could occur during the life of new loans. For this reason, the older loans have been retained in the averages SBA uses to estimate the subsidy costs of new loans. According to both OMB and SBA officials, there may be a number of iterations leading up to the final estimate of the credit subsidy rate and the associated request for budget authority that are shown in the President's budget.

In addition to estimating the credit subsidy rate for SBA-guaranteed loans, the OMB model uses the cash flows prepared by SBA to report three components of the estimate: (1) net defaults (claim payments minus

¹¹See Issue Paper 96-CR-7, May 1, 1996 of the Government-Wide Audited Financial Statements Task Force.

¹²See Homeownership: Appropriations Made to Finance VA's Housing Program May be Overestimated, [GAO/RCED-93-173](#), Sept. 1993 and Mortgage Financing: FHA Has Achieved Its Home Mortgage Capital Reserve Target, [GAO/RCED-96-50](#), Apr. 1996.

recoveries), (2) fees received, and (3) any other cash flows associated with the program. By splitting the estimate into components, the model indicates how each of the cash flows affects the overall credit subsidy rate estimate.

In addition to requiring agencies to estimate the credit subsidies associated with new government-backed loans, credit reform requirements provide for subsequent re-estimates and modifications of credit subsidy estimates. To calculate re-estimates, SBA uses a process very similar to the one described above to project the cash flows associated with existing loans. Re-estimates are calculated after the end of the fiscal year in which the loans are guaranteed. However, the estimated credit subsidy rate may be modified during that year to reflect enacted legislation and certain administrative actions that alter the subsidy cost. A modification does not include government actions permitted within the terms of existing contracts or through other existing authorities. Furthermore, credit subsidy estimates may not be revised mid-year due only to changes in “forecast technical” assumptions, such as expected claims.

Why the Estimated Credit Subsidy Rates Increased in 1997

According to the President’s budget for fiscal year 1997, the estimated credit subsidy rate for the 7(a) program increased from 1.06 percent for loans made in 1996 to 2.68 percent for loans made in 1997. For the 504 program, the estimated rate increased from zero to 6.85 percent, assuming no future program changes.¹³ The estimates for the 1997 loans were higher largely because SBA modified the cash flow projections that it had used for the fiscal year 1996 and earlier estimates. According to SBA and OMB officials, SBA modified the cash flows to incorporate the results of an intensive analysis of data on the performance of loans made in the past. In addition, the fiscal year 1997 estimate for the 7(a) program was affected by a spreadsheet error unnoticed by either SBA or OMB; without this error, the estimated credit subsidy rate in SBA’s budget submission would have been about 2.03 percent. Appendix III summarizes the factors responsible for these changes in SBA’s estimates.

SBA Developed a New Loan Performance Database in 1995

As part of its planned efforts to meet credit reform requirements, SBA developed a loan performance database in 1995. The objectives of this effort were to (1) provide access to the data on historical loan

¹³These are the “current services” credit subsidy estimates, according to the 1997 budget. The current services estimate assumes no future changes to the programs.

performance on a cohort basis¹⁴, (2) update the subsidy estimates on the basis of the historical data, (3) allow SBA to analyze loan performance on the basis of multiple-risk indicators, and (4) annually validate past subsidy estimates. SBA officials used the database for the first time while preparing the estimates of credit subsidy rates for the 1997 budget.

All estimates of credit subsidy rates for loans guaranteed prior to 1997 had been based on the limited loan performance data resulting from a review of the loan portfolio undertaken in 1991. According to SBA and OMB officials, this 1991 review had several weaknesses. Most importantly, it did not utilize transaction-based data, but rather relied on the interpretation of changing loan balances over time to estimate loan performance. Furthermore, it was based on data that were not easily identified by cohort (i.e. by a particular year of loan guarantee commitments). In addition, the results of the 1991 review were not updated to reflect the actual performance of loans in fiscal years 1992 through 1995. According to SBA officials, the new loan performance database—which is updated annually to include recent data—corrected these problems. We did not assess the quality of the data in SBA’s new loan performance database.

Revised Cash Flows and Spreadsheet Error Contributed to Change in 7(a) Program Estimate

In 1995, when SBA prepared its 1997 budget request, the loan performance database confirmed earlier estimates that, during the life of each year’s loans, SBA makes claim payments for defaulted loans equal to about 13 percent of the original loan disbursements.¹⁵ However, the database also indicated that SBA recovers less of the claim amount through the liquidation of loan collateral—about 50 percent rather than the 56 percent indicated by the 1991 review. In addition, the analysis of the database indicated that the timing of defaults was different than estimated in the 1991 review; specifically, a greater percentage of the defaults would occur earlier. Incorporating this change slightly increased the estimates of credit subsidy rates because the earlier a cash outflow occurs for SBA, the higher the present value of the cost to SBA. These changes to the estimates of claims and recoveries accounted for about 45 percent of the increase in the fiscal year 1997 credit subsidy estimate.

A second factor, accounting for about 15 percent of the increase, was SBA’s lowered forecast of revenues from fees. When preparing the fiscal year

¹⁴In the case of SBA’s 7(a) and 504 programs, a “cohort” of loans consists of all of the loan guarantees committed through each program during a given fiscal year.

¹⁵Although we refer to claims throughout this statement as a percentage of the total dollar amount of the loans disbursed, SBA typically defines the claim rate as a percentage of the SBA-guaranteed portion of disbursements.

1996 credit subsidy estimate, SBA had not accounted for the loss in annual fee revenue that occurs when borrowers prepay their loans. (Because annual fees are charged on outstanding loan balances, and prepayments cause those balances to be lower than they would otherwise be, prepayments effectively reduce SBA's revenues from fees.) For the fiscal year 1997 estimate, SBA added an estimate of prepayments. Furthermore, SBA reduced its estimate of the amount of revenues it would receive through the secondary-market fee, based on lower-than-expected revenue from the first year of experience with the new fee.

Finally, an error in applying SBA's cash flow projections to OMB's discounting model accounted for about 40 percent of the increase in the credit subsidy estimate in 1997. This error caused the estimated credit subsidy for the 7(a) program to be expressed as a percentage of the guaranteed portion of the loans, rather than of their total face amount. SBA projected that it would guarantee on average about 76 percent of the fiscal year 1997 loan cohort. Because critical cells in SBA's cash flow spreadsheet were based on the number of dollars guaranteed instead of the number of dollars disbursed (that is, the total face amount of the loans), SBA's estimated credit subsidy rate was higher by about 32 percent (1 divided by 0.76, the average guaranteed portion).

This error went unnoticed by both SBA and OMB officials responsible for reviewing the 7(a) credit subsidy rate estimate. If SBA or OMB officials had compared the component data generated by OMB's discounting model for the erroneous 1997 estimate with the components of the 1996 estimate, they would have seen an unexplainable increase in the fee revenue component (there was no increase in the fee rates charged). According to standards developed by the Federal Accounting Standards Advisory Board, subsidy estimate component data should be used to monitor and make decisions about the federal government's credit programs.¹⁶

On the basis of its appropriated budget authority of \$198.5 million,¹⁷ SBA announced that it could guarantee an additional \$2.47 billion in 7(a) loans because the credit subsidy rate estimate should have been lower. We are currently reviewing the changes in estimates over time for selected programs at five agencies as part of an assessment of the implementation

¹⁶See Statement of Federal Financial Accounting Standards Number 2, Accounting for Direct Loans and Loan Guarantees, August 23, 1993. These standards were developed by the Federal Accounting Standards Advisory Board which is composed of representatives of the Department of the Treasury, OMB, GAO, the Congressional Budget Office, several other federal agencies, and from the private sector.

¹⁷This figure includes an appropriation of \$158 million and carryover budget authority of \$40 million.

of the Credit Reform Act. We are also preparing a report on OMB's automated discounting model. We expect to report on these efforts later this year.

Revised Estimates of Claims and Recoveries Caused Higher Subsidy Estimate for 504 Program

The analysis of the loan performance database of loans made through the 504 program in prior years showed more dramatic changes than for the 7(a) program. According to SBA officials, the 1991 review substantially underestimated claim rates and overestimated recovery rates because it did not consider a substantial portion of the 504 loan transactions. This occurred because the 1991 review inaccurately assumed that the accounting structure for the 7(a) and 504 programs was the same. However, unlike the 7(a) program, 504 transactions may be recorded under different identification numbers in SBA's accounting system than the original debenture. Because the 1991 review included only transactions recorded under the original debenture's identification number, it erroneously omitted relevant data on claims and recoveries. According to SBA officials, the new loan performance database corrects this error by recognizing all transactions associated with the debentures made during each year.

In the fall of 1995, SBA used the expanded historical data on the 504 program made available through the loan performance database in preparing the fiscal year 1997 cash flow projections. SBA forecast that it would (1) make claim payments during the life of a year's loans equal to about 19 percent of the face value of the loans, more than twice the 7 percent estimate indicated by the 1991 review, and (2) recover about 40 percent of the claim amount through the liquidation of loan collateral, or about half of the 80 percent estimate indicated by the 1991 review. The estimate of the total recovery rate in the 1997 cash flows should have been even lower (33 percent), according to OMB and SBA officials.¹⁸ The 40-percent estimate was based on an error in accumulating the historical data that was corrected when SBA prepared its 1998 estimates, according to SBA officials.

¹⁸Using a lower total recovery rate would have increased the credit subsidy rate estimate above the 6.85 percent rate estimated by SBA.

Estimates for 1998 Budget Reflect Updates to Cash Flow Projections

Since the 1997 estimates were prepared, SBA has made additional revisions to its cash flow projections. For the 7(a) program, these changes resulted in an estimated subsidy rate of 2.32 percent, assuming no future program changes, for loans to be made in 1998 and a re-estimate of the rate for loans made in 1996 of 2.4 percent.¹⁹ In preparing these estimates, SBA did not repeat the spreadsheet error that had inflated the 1997 estimate. Nevertheless, the estimates prepared during the 1998 budget process are higher than the corrected budget request estimate (2.03 percent) for the 1997 loans because SBA reduced the expected fee revenues from these loans. Specifically, SBA increased its estimate of prepayments—even further than during preparation of the 1997 estimates.

SBA increased its estimate of prepayments because it obtained for the first time historical data maintained by Bloomberg Financial Services on the percentage of loans each year that were prepaid. These data are based exclusively on 7(a) loans sold through the secondary market. When preparing the 1997 estimates, SBA assumed that up to about 2.5 percent of the amount of the loans outstanding each year would be prepaid.²⁰ However, the historical data obtained from Bloomberg Financial Services showed that in some years of their lives as many as 10 percent of the amount of the loans could be expected to be prepaid.

In addition to changes in expected revenues from fees, SBA made small changes to its claim payment and recovery forecasts. Specifically, SBA (1) decreased its expected claim payments over the life of the loans from about 13 percent of the loans' face value to about 12 percent, on the basis of additional historical data on loan performance in fiscal year 1996, and (2) increased the total recovery rate from about 50 percent of expected claim payments to about 51 percent over the life of the loans, on the basis of recent successes in the Liquidation Improvement Project.

For the 504 program, SBA (1) increased estimated prepayments; (2) lowered its expected claim payments for defaulted loans from about 19 percent of the loans' face value to about 16 percent over the life of the loans; and (3) lowered expected recoveries from 40 percent to 34 percent of claims. When calculating the 34-percent recovery rate estimate, SBA corrected the accumulation error discussed earlier and adjusted the

¹⁹The previous estimate of the credit subsidy rate for loans made through the 7(a) program in 1996 was 1.06 percent.

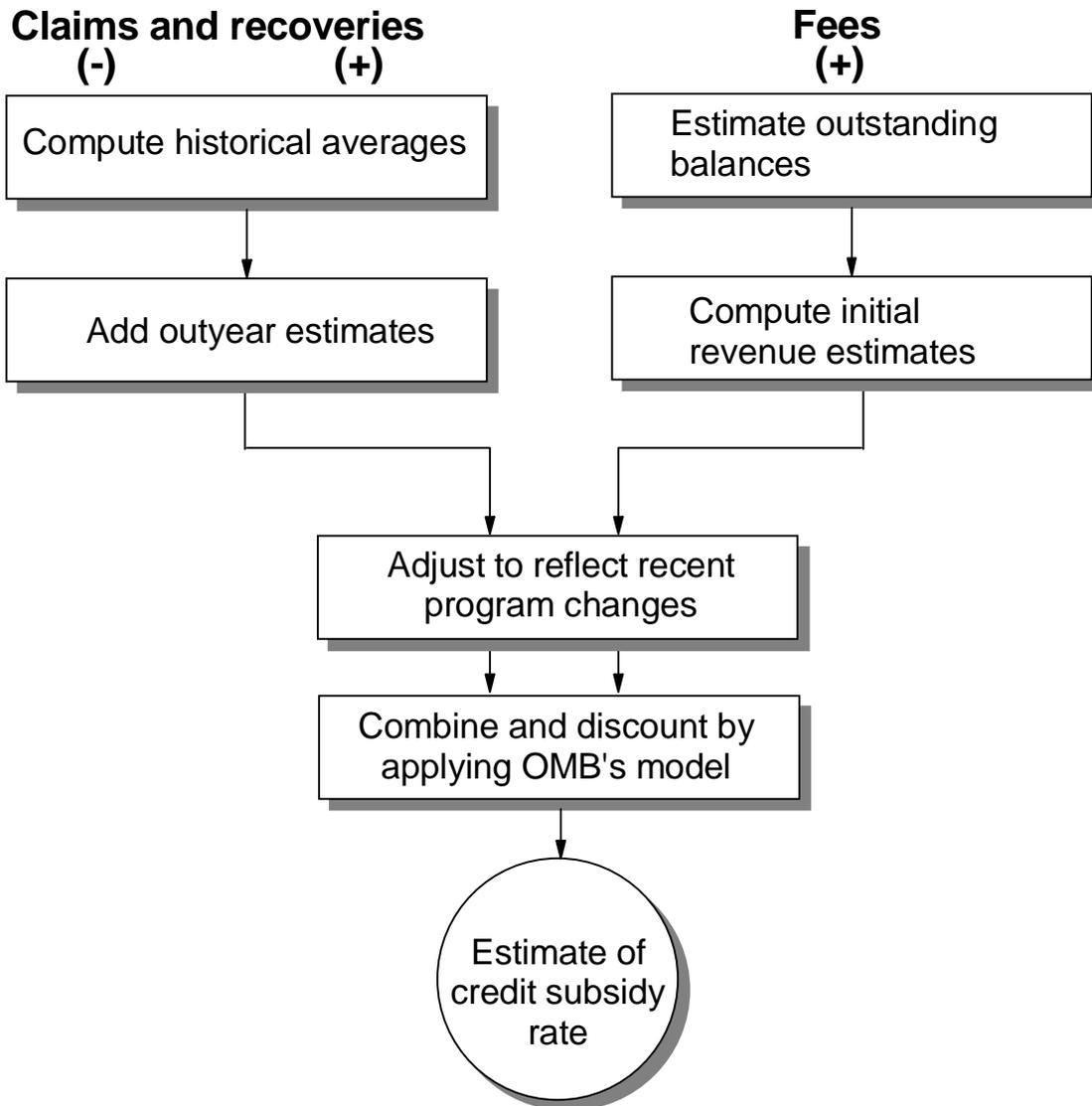
²⁰Although we refer to prepayments as a percentage of the total dollar amount of the loans disbursed, SBA typically defines prepayment rates as a percentage of the SBA-guaranteed portion of disbursements.

estimate upward to reflect the improvements in recoveries expected to result from the Liquidation Improvement Project, according to SBA officials. With these changes in expected revenue from fees, claims, and recoveries, SBA re-estimated the credit subsidy rate for the loans made through the 504 program in 1996 at 7.54 percent. The estimate for the 1998 loans is zero because the annual fees charged to borrowers and lenders were increased dramatically after SBA prepared its budget request estimate for the 1997 loans.²¹ With recoveries, these fees are expected to cover all of the costs incurred by SBA for defaulted loans.

Mr. Chairman, this concludes my prepared remarks. We will be pleased to respond to any questions that you or other Members of the Committee might have.

²¹This increase in the fee rate also prompted a lowering of the credit subsidy rate estimate for 504 loans made in 1997 from 6.85 percent (budget request) to zero (budget execution).

How Credit Subsidy Rate Estimates Are Prepared



Primary Reasons for Changes in Credit Subsidy Rate Estimates

	7(a)		504	
	1996 → 1997	1997 → 1998	1996 → 1997	1997 → 1998
Lower estimated fees based on data on prepayments and/or secondary market fees	✓	✓		
Lower estimated recoveries based on expanded data	✓		✓	
Higher estimated claims based on expanded data			✓	
Higher annual fee rate				✓
Spreadsheet error	✓			

Note: Based on the 1996 budget execution estimates and the 1997 and 1998 budget request (current services) estimates.

Changes in Cash Flow Projections

Table 3.1: Changes in Projections Underlying SBA's Estimates of the 7(a) Credit Subsidy

	1996 (percent)	1997 (percent)	1998 (percent)
Fees			
Prepayments ^a	0	Up to 2.5 in peak year	Up to 10 in peak year
Secondary-market fees ^b	0.14	0.02	0.03
Claims^c	13	13	12
Recoveries^d	56	50	51
Other			
		Spreadsheet error inflated credit subsidy estimate by 32 percent.	
Credit subsidy estimate ^e	1.06 ^f	2.68 (2.03) ^g	2.32

^a Prepayments are shown as an annual percentage of the loans outstanding in the first 10 years. (SBA typically shows prepayments differently—as a percentage of SBA's share of outstanding loans.)

^b Secondary market fees are shown as a percentage of the original disbursements.

^c Claims are shown as a percentage of the original disbursements. (SBA typically shows claims differently—as a percentage of SBA's share of disbursements.)

^d Recoveries are shown as a percentage of claims.

^e Estimates shown are the 1996 budget execution estimate and the 1997 and 1998 budget request (current services) estimates.

^f Re-estimated at 2.40 percent in the 1998 budget.

^g Without the spreadsheet error, the 1997 budget request estimate would have been about 2.03 percent.

Source: GAO's analysis of SBA's and OMB's data.

Appendix III
Changes in Cash Flow Projections

Table 3.2: Changes in Projections Underlying SBA's Estimates of the 504 Credit Subsidy

	1996 (percent)	1997 (percent)	1998 (percent)
Fees			
Prepayments ^a	0	0	Up to 4 in peak year
Annual fee rate ^b	0.125	0.125	1.084
Claims^c	7	19	16
Recoveries^d	80	40	34
Credit subsidy estimate ^e	0.00 ^f	6.85	0.00

^aPrepayments are shown as an annual percentage of the loans outstanding in the first 10 years. (SBA typically shows prepayments differently—as a percentage of SBA's share of outstanding loans.)

^bThe annual fee rate is shown as a percentage of the loans outstanding annually.

^cClaims are shown as a percentage of the original disbursements. (SBA typically shows claims differently—as a percentage of SBA's share of disbursements.)

^d Recoveries are shown as a percentage of claims.

^e Estimates shown are the 1996 budget execution estimate and the 1997 and 1998 budget request (current services) estimates. Although the 1996 and 1997 estimates are based on all loans made through the 504 program, the 1998 estimate shown here excludes loans made through the Defense Loan and Technical Assistance program.

^fRe-estimated at 7.54 percent in the 1998 budget.

Source: GAO's analysis of SBA's and OMB's data.

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