



GAO

Accountability \* Integrity \* Reliability

United States General Accounting Office  
Washington, DC 20548

Resources, Community, and  
Economic Development Division

B-284140

December 15, 1999

The Honorable Donald A. Manzullo  
Chairman, Subcommittee on Tax,  
Finance, and Exports  
Committee on Small Business  
House of Representatives

Subject: Small Business Administration: A Review of SBA's Estimate of Impact of  
Legislative Proposals for the 7(a) Loan Guarantee Program

Dear Mr. Chairman:

On July 29, 1999, the House Small Business Committee reported out H.R. 2615, which included provisions to modify the Small Business Administration's (SBA) 7(a) loan program.<sup>1</sup> These provisions include (1) increasing the maximum portion of a loan that SBA may guarantee from \$750,000 to \$1 million, (2) adding incentives to encourage lenders to make small loans of \$150,000 or less,<sup>2</sup> (3) placing a cap of \$2 million on the total size of a loan that SBA may guarantee, and (4) imposing a penalty for the early prepayment of some loans.<sup>3</sup> SBA prepared two estimates of the impact that these legislative proposals would have on the average size and number of loans that it guarantees. First, in a June 29, 1999, response to you, SBA estimated the impact of an increase in the maximum loan guarantee on the availability of small loans. SBA concluded that increasing the guarantee would result in its guaranteeing fewer loans. Second, SBA estimated the collective impact—on the average size of loans and on the volume of loans guaranteed—of increasing the maximum guarantee and including the small loan incentives and the \$2 million cap. According to SBA officials, the second response was provided to your staff on July 29, 1999, and to the Committee staff on an earlier date. SBA concluded that implementing these proposals together would not affect the average size and number of loans that it guarantees. According to SBA, both estimates were prepared within a short time of being requested. SBA officials also stated that they intended these estimates to represent their best judgment within the time available.

SBA worked with the Congressional Budget Office (CBO) to estimate the proposals' impact on the credit subsidy rate. The credit subsidy rate is the net present value of the federal costs

---

<sup>1</sup> The House passed H.R. 2615 on Aug. 2, 1999.

<sup>2</sup> The three incentives are (1) increasing the loan guarantee percentage from 75 percent to 80 percent for loans of more than \$100,000 but less than or equal to \$150,000; (2) reducing the guarantee fee from 3 percent to 2 percent for loans of more than \$100,000 but less than, or equal to, \$150,000; and (3) allowing lenders to retain one-quarter of the 2-percent guarantee fee on loans of \$150,000 or less.

<sup>3</sup> The penalty applies to loans with terms of 15 years or more that are prepaid within the first 3 years.

expected per dollar loaned through the program. CBO and SBA determined that the proposals would not result in a significant change in the credit subsidy rate.

You asked us to describe how SBA prepared these estimates of the legislation's impact on the average size of loans and the number of loans SBA makes and, if appropriate, recommend ways that SBA could have improved its estimates. You further asked us to describe how SBA analyzed the impact of the legislative proposals on the credit subsidy rate for the 7(a) loan program and, if appropriate, recommend ways to improve this analysis.

In summary, we found:

- SBA's estimates of the legislative proposals' impact on the average size of loans and the volume of loans represent the professional judgment of SBA's loan program officials. SBA's analysis could have been enhanced had it considered, within the available time, factors such as (1) the relative size of the program change, as compared with prior program changes; (2) the upward trend in the average loan size; and (3) the economic context surrounding historical changes to the program.
- With respect to its estimate of the impact of the legislative proposal on the credit subsidy rate, SBA used a cash-flow model that incorporated the legislative changes in H.R. 2615. SBA's conclusion that the legislative proposal would not significantly change the credit subsidy rate is based on assumptions regarding cash flows that appear optimistic. That is, the prepayment assumptions were more optimistic than the cash flows used to prepare the fiscal year 1998 financial statements, which received an unqualified audit opinion.

#### **SBA's Assessments of the Impact of Legislative Proposals on Average Loan Size and Loan Volume Were Based on Professional Judgment**

For both estimates, the assessments of SBA officials were based on their professional judgment and a consideration of historical program data. SBA officials did not document their analysis and cannot explain how the various factors they considered were weighed in their assessment. SBA officials believed that their approach to estimating loan volume provided results similar to those that could have been obtained through more rigorous methods. Furthermore, SBA officials noted that they did not have the econometric modeling experience, the tools, or the time to prepare more rigorous estimates. Finally, SBA officials stated that they intended these estimates to represent their best judgment only. Nonetheless, we believe that within the time available, SBA could have considered other relevant issues.

In its June 29, 1999, estimate of the effect of increasing the loan guarantee amount from \$750,000 to \$1 million, SBA relied on its experience with a \$250,000 increase in the loan guarantee amount that occurred in 1988. Specifically, in fiscal year 1988, the maximum guarantee for 7(a) loans was increased from \$500,000 to \$750,000. From fiscal year 1988 through fiscal year 1990, the average size of a 7(a) loan grew from \$213,300 to \$247,900—a 16-percent increase. SBA concluded that a similar increase of \$250,000 in the maximum guarantee amount (in this case from \$750,000 to \$1 million) would also result in a 16-percent increase in average loan size—from \$230,000 to \$267,000. According to SBA, such an increase would result in the agency's funding 6,400 fewer loans (assuming total program funding of \$10.5 billion).

The credibility of the estimates could have been enhanced if other factors, such as the following had been considered:

- First, the \$250,000 increase in the loan guarantee amount made in 1988 represented a 50-percent increase from the \$500,000 base. The current legislative proposal represents a 33-percent increase in the loan guarantee amount (\$250,000 from a \$750,000 base). A 33-percent increase in the loan guarantee amount would likely lead to a smaller increase in the average loan size than the 16-percent increase that occurred when the maximum loan guarantee amount was increased by 50 percent.
- Second, SBA officials did not incorporate the upward trend in the average loan size into their analysis. The average loan size increased by about 13 percent from 1986 through 1988. Given this upward trend in average loan size, one would expect that the impact of the 1988 program change was less than the observed 16-percent increase in average loan size, although SBA officials attributed the entire 16-percent increase to the change.
- Third, general economic conditions in 1999 differ from those in 1988, when the first program change occurred. For example, the prime interest rate<sup>4</sup> is currently 1.75 percentage points lower today than it was during 1988. Such a difference in the state of the economy will influence the demand for commercial loans and thus possibly the impact of a program change.

SBA officials believe that these factors are appropriate to consider but disagree that including these factors would have been any more appropriate than SBA's chosen approach. We believe that including all appropriate factors would have helped SBA improve the credibility of its estimates, even if the estimates themselves would have been the same.

According to SBA officials, on July 29, 1999, SBA provided your staff its second estimate of the effect on loan size and volume of legislative changes. This estimate considered not only increasing the loan guarantee limit from \$750,000 to \$1 million but also adding the small loan incentives and implementing a \$2 million cap. While SBA officials believe that raising the guarantee amount to \$1 million would increase the average size of loans, adding the small loan incentives would both increase the demand for smaller loans and encourage lenders to offer them. Thus, SBA officials concluded that the proposals would offset each other and that the number and size of loans SBA guarantees would be unchanged.

Like the earlier estimate, this estimate was based on professional judgment, and SBA did not document its analysis. SBA did not prepare a precise estimate of the impact the incentives for small loans might have on loan size and volume. To determine the impact of the three incentives for small loans, SBA considered other agency programs that had undergone similar changes. SBA's loan volume data showed that three of its loan programs—the Export Working Capital program, the SBAExpress program, and the LowDoc program—had an increase in loan volume when changes were made in the programs.<sup>5</sup> However, SBA could not document how it came to this conclusion. In addition, SBA's experience with changes to the LowDoc and SBAExpress programs may not be comparable to the impact that the three

<sup>4</sup>Interest rates for SBA loans are negotiated between the borrower and the lender but are subject to SBA maximums, which are pegged to the prime rate. The prime rate is a key indicator of interest rates charged to commercial borrowers by banks.

<sup>5</sup>Under the Export Working Capital program, SBA guarantees up to 90 percent of a secured loan or \$750,000, whichever is less. The LowDoc and SBAExpress programs streamline the lending process. The LowDoc program uses a shortened, one-page application, to which SBA responds within 36 hours. The SBAExpress program allows lenders to use their own application forms for loans up to \$150,000 with a 50-percent guarantee rate.

currently proposed incentives could have on the size of average loans. That is, while both sets of changes encourage lenders to make small loans, they do so in different ways, and therefore the magnitude of the impact could be different.

### **SBA's Analysis of the Impact of Legislative Proposals on Credit Subsidy Rate Appears Optimistic**

According to a director in SBA's Office of the Chief Financial Officer, in order to estimate the impact on the credit subsidy rate, SBA used a cash-flow model that incorporated the changes in H.R. 2615. SBA modeled the proposed legislation, assuming there would be no change in the volume and mix of loans.<sup>6</sup> According to SBA, any increase in the subsidy rate from the small loan incentives is more than offset by the decrease in the subsidy rate resulting from the provision of the prepayment penalty. Overall, SBA estimated that the credit subsidy rate would decline from 1.16 to 1.12 percent.

SBA's estimates of the credit subsidy rate resulting from the proposed legislation may be optimistic. While including the legislative provision for a penalty imposed on the early prepayment of loans, SBA's model assumed an increase in the frequency with which borrowers prepay their loans within the 3-year period in which the penalty applies. However, according to CBO, one should expect the frequency of prepayments to decline when a prepayment penalty is introduced. If the prepayment rate were reduced, the prepayment penalties might not offset the increase in the subsidy rate from the small incentives, as SBA estimated. However, CBO found that the overall impact of the legislative proposals on the credit subsidy rate was negligible. We did not perform a detailed analysis of SBA's credit subsidy model or determine its reasonableness.

### **Scope and Methodology**

To gather information on SBA's analysis for determining the impact of the legislative proposals under H.R. 2615, we met with officials from SBA's Office of Financial Assistance, Office of Congressional and Legislative Affairs, and Office of the Chief Financial Officer. We also reviewed program and budget information from SBA.

We conducted our work from October 1999 through November 1999 in accordance with generally accepted government auditing standards.

### **Agency Comments**

We provided a draft copy of this report to the SBA for its review and comment. We spoke with the Associate Administrator for SBA's Financial Assistance office and other SBA officials, who said that the draft of this report implied that their estimates were intended as a scientific modeling methodology and that we did not recognize the time constraints under which they prepared the estimates. Furthermore, they believe that their methodology was sound and the consideration of additional conditions would not result in any significant difference in the final estimates. In response, we revised the report to make clear that we do not suggest that, within the time that SBA had to prepare the estimates, it should have used sophisticated modeling technique, such as economic forecasting. In addition, we revised the report to emphasize the amount of time SBA had to prepare the estimates, and we added information to better describe how SBA intended to portray these estimates.

---

<sup>6</sup>According to an official of SBA's Office of the Chief Financial Officer, the size of loans has little influence on credit subsidy rate.

With regard to the time SBA had to prepare these estimates, SBA officials said that the time they had to prepare their estimates was imposed by the requesters. The first estimate was provided to your staff within 3 days of being requested. The second estimate was provided to Committee staff the same day it was requested by them and to your staff 6 days later, according to SBA officials. However, SBA did not have a record of how much time it had to prepare these estimates. Nonetheless, we believe that SBA, within the time it says it had, could have improved the credibility of its estimates had it considered other relevant factors, which could include the three that we discuss in the report. SBA officials said that they would take our concerns into consideration when preparing estimates in the future. The SBA officials also provided technical changes, which we have made, as appropriate.

-----

We are sending copies of this report to interested congressional committees and the Honorable Aida Alvarez, Administrator of SBA. We will also make copies available upon request.

Please call me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report were Michael Clements, LaSonya Roberts, and Mathew Scire.

Sincerely yours,



Stanley J. Ozerwinski  
Associate Director, Housing and  
Community Development Issues