NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

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

Testimony before the Subcommittee on Economic Growth, Tax, and Capital Access of the House Committee on Small Business

April 10, 2019

Submitted by
Tony Wilkinson, CEO and President
NAGGL
Dallas, Texas

Chairman Kim, Ranking Member Hern, and Members of the Subcommittee—my name is Tony Wilkinson and I have served as the CEO and President of the National Association of Government Guaranteed Lenders (NAGGL) since December 1987. NAGGL is a national trade association of approximately 800 banks, credit unions, non-depository lenders and other entities that participate in the Small Business Administration's 7(a) loan guarantee program. NAGGL's lender members are responsible for approximately 80% of the total 7(a) loans made each year. I began as a Director in this trade association almost 35 years ago while serving as a lender in Oklahoma, and I am proud to say that since then, NAGGL has been working hand in hand with the House Committee on Small Business on the most pressing issues for small business borrowers and lenders in the 7(a) industry. Thank you for continuing our practice of tackling the tough challenges together by having this hearing today to discuss the grave danger in which the President's FY20 budget submission has placed the 7(a) program.

At the heart of the SBA's success is its flagship 7(a) lending program, the agency's largest source of access to capital for small business borrowers across the country. The numbers tell a story of great success in the 7(a) program. In Fiscal Year (FY) 2018, financial institutions large and small provided about $25.4 billion in approvals to about 60,350 small businesses nationwide through the SBA 7(a) program. Roughly 543,100 jobs were created or retained just last year thanks to the SBA 7(a) program-- if we assumed just $30,000 in average annual wages for those employees affected by the program, that means the 7(a) program is responsible for supporting at least $16.3 billion in income across the country. The impact does not stop with just those topline numbers—there are other benefits that are often hard to measure, like employment opportunities, increased tax revenue for federal and local governments, and community growth driven by small business expansion in cities, small towns and rural areas across the country. There is a never-ending domino effect of benefits gained from the 7(a) loan program.

The performance metrics also tell a success story. I am pleased to report that the performance of the SBA 7(a) loan portfolio has remained sound. Repurchase rates on defaulted loans remains near an all-time low, while recovery rates on collateral is at an all-time high. Putting the two together, SBA reports a record-low charge off rate for the portfolio in FY 2018.

Over the past two Congresses, this Committee and its colleagues on the Senate Committee on Small Business and Entrepreneurship have been incredibly active in taking a closer look at the 7(a) loan program, and as a result, a number of historic legislative accomplishments were realized last year by updating the *Small Business Act*. By far, the most significant achievement in the access to capital programs for the Committee and its Senate colleagues was drafting and passing into law the *Small Business 7(a) Lending Oversight Reform Act of 2018*, a bipartisan, bicameral effort that spanned three and a half years of work on the part of this Committee and staff. The 7(a) lending industry partnered with the Committee every step of the way to refine and create stronger oversight standards—it is not lost on the 7(a) lending industry that we have the *privilege* of being stewards of a government program with a public mission that must operate with integrity.

However, this year, we are presented with a different kind of challenge—one which threatens the ability of the 7(a) program to create and grow access to capital for the tens of thousands of borrowers that we serve. The President's FY20 budget request, presented a little over three weeks ago to Congress, sent a shock wave through the 7(a) industry when it included a subsidy calculation requiring additional funding of 33 basis points (0.33%), or $99 million, for the 7(a) program. This is a major shift from the program's track record of operating at zero subsidy since FY05 (except during the years covered by the Recovery Act), which means that the fees collected from borrowers and lenders cover were projected to cover the cost of making the loans. By projecting a positive subsidy rate for FY20, the budget request is triggering the necessity for Congressional action. Now, Congress needs to either appropriate $99 million to the 7(a) program or amend the *Small Business Act* to raise the current fee caps in order to collect $99 million in additional fees from borrowers and lenders on top of what participants already pay to cover the cost of the program. Both of these paths forward will need to pass the Senate, House, and be signed into law by the President by September 30—or the 7(a) program will shut down on October 1.

The positive subsidy rate from SBA and OMB has placed Congress in a tough predicament. This industry has been proud of the fact that we operate at zero cost to the taxpayer, and we acutely recognize the challenges appropriators face to stay within spending caps each fiscal year. On the other hand, raising fees on small business borrowers and lenders will shrink and impede access to capital, creating more barriers for the program's participants—the exact opposite direction we all would hope to see this program move toward. SBA's FY20 budget has created a lose-lose scenario for Congress, industry, and the country's small businesses.

But before we can even consider how Congress might best move forward to prevent a very successful, popular small business program from simply shutting down on October 1, we *must* first collectively question the positive subsidy calculation. **My plea to this Committee is that before you simply take the FY20 subsidy calculation at face value, you first challenge both OMB and SBA to explain this subsidy estimate in detail, and specifically, the assumptions that went into the calculation and how those assumptions are weighted in the subsidy model.** Not only do the FY20 budget documents provide insufficient justification for a $99 million increase in estimated subsidy costs, but there is ample evidence to suggest that a troubling pattern exists in the way SBA and OMB model the subsidy cost. This testimony will walk this Subcommittee through a number of overwhelming factors that should leave us all with more questions than answers.

I am not the only one asking questions. The Government Accountability Office (GAO) has been raising the same concerns about SBA's ability to appropriately estimate the cost of the 7(a) portfolio before this Committee and Congress since 1997, spanning multiple Administrations. In a series of reports, GAO has looked into the accuracy of SBA's subsidy rate- or lack thereof- no less than on four occasions over the past twenty-two years—this is a pattern, and one we cannot ignore. I will be referencing a number of GAO's findings throughout my testimony to highlight concerns with SBA's cost estimates that are shared by both GAO and industry.

Allow me to also take the time to briefly explain what a subsidy calculation is and how this is reported every fiscal year. The 7(a) subsidy calculation is an estimate of the cost of the loan program to the government for loans originated in a given fiscal year and is governed by the *Federal Credit Reform Act of 1990* (FCRA). This statute dictates that the cost of credit portfolios shall be the net present value of the portfolio, excluding administrative costs to the government. By enacting FCRA, Congress delegated to the Executive branch the responsibility for estimating the future credit performance of loans into a subsidy rate, which Congress then uses to determine any necessary appropriations for each fiscal year.

The majority of the Administration's budget requests are just that—proposals that make up a sort of budget wish list from the Executive branch to Congress. Some of these proposals in this year's budget request will always stay proposals—for instance, I expect Congress will once again not act on charging all borrowers and lenders to pay for SBA's employees' salaries and expenses in what the budget calls "counter-cyclical measures," namely because it is an egregious violation of FCRA. However, the portion of the FY20 budget request that is <u>not</u> a proposal is the statement of a positive subsidy. SBA's proposed fee increases to borrowers and lenders in order to cover the positive subsidy *is just a proposal*, giving Congress one option to cover the cost this fiscal year, and we all know that there are more options than the increased fee structure SBA presented. But Congress <u>does not have a choice but to react and address</u> the fact that the 7(a) program has a positive subsidy calculation starting the first day of the new fiscal year—and Congress has been given a limited timeframe in which to do so. Otherwise, absent a way to cover the stated costs for FY20, the program will not be permitted to operate past September 30.

Why is the 7(a) industry questioning the FY20 subsidy calculation?

Performance—Discrepancy Between Actual v. Projected
First, the portfolio's actual performance data projects a starkly different picture than this positive subsidy estimate would suggest. Since the subsidy calculation is the projected performance of the portfolio, it stands to reason that SBA may have detected a significant decline in the current performance of the portfolio to lead them to this conclusion. However, by SBA's own reporting to Congress and the industry, the health of the 7(a) portfolio is strong. The portfolio has seen a steady decline in charge-off rates over the past ten fiscal years on an annualized basis and risk has generally declined since September 2012.

In fact, there is a significant discrepancy over actual portfolio performance and projected performance in FY20. The program's five year average recovery rate on defaulted loans, as reported to Congress last December, was 50%. In sharp contrast, the FY20 budget assumes a projected recovery rate of only 37.29%. Why has the subsidy modeling ignored this established trend of steadily increasing recovery rates?

GAO reports on SBA's subsidy calculations have highlighted this very issue of repeated discrepancies between actual loan performance and projected performance. In an August 2001 GAO letter and briefing to the Senate and House Committees on Small Business titled "Section 7(a) General Business Loans Credit Subsidy Estimates," **GAO describes a consistent pattern of SBA's estimations showing a marked disconnect with actual performance, resulting in repeatedly overestimating the cost of the program**. GAO states "review of actual and originally estimated defaults and recoveries showed that, on a cumulative basis since 1992, defaults were overestimated by approximately $2 billion… During this same period, SBA overestimated the cost of the 7(a) program by $958 million as evidenced from a trend of downward reestimates. The majority of these downward reestimates can be attributed to the overestimate of defaults." GAO goes on to explain that at the time, SBA was in the midst of proposing a new methodology to OMB that uses the 5 most recent years of actual loan performance, rather than all actual loan performance which can often include anomalies from various economic cycles that have no bearing on the current economic climate. Since this 2001 report, SBA's model has been adjusted and there has been a shift to a more sophisticated econometric modeling that attempts to create relationships between performance and economic trends and other indicators—but it seems more pertinent than ever for Congress and industry to understand how SBA and OMB currently utilize historic loan performance and for what period of time given what seems to be history repeating itself.

Pattern of Overcharging Borrowers, Lenders, and Congress
Another concerning element of the FY20 budget request that should lead to many questions about the accuracy of the 7(a) model is the documentation of repeated and significant downward re-estimates in every cohort of loans since FY10, as reported in the FY20 budget. Downward re-estimates mean that the portfolio is consistently performing *better* than originally projected in each fiscal year's original subsidy

calculation, and that the model used by SBA and OMB has been significantly overestimating program costs. In other words, data that shows in dollars the net lifetime amount of a particular fiscal year's downward re-estimate is how much borrowers and lenders have been *overcharged* in fees to cover the cost of the program. These excess charges are simply returned to the Treasury as miscellaneous receipts.

In the FY20 budget, SBA reported for FY18 a $757 million excess subsidy reserve that captured re-estimates from all prior years over what had been reported for FY17, and another $143 million is already expected for FY19. These are not isolated incidents – overfunded subsidy reserves have occurred for every cohort of 7(a) loans since FY10. In fact, since FY10, borrowers and lenders have been overcharged by approximately $3.2 billion, all transferred to the Treasury as miscellaneous receipts during that period. This is a staggering amount of money that has unnecessarily burdened the delivery of these important small business loans, and is a clear indication of the degree to which the process for developing 7(a) subsidy estimates appears to be badly broken. A subsidy model certainly cannot be perfect and it is wrong to expect that it will ever be a perfect estimation—but a pattern this egregious is concerning, especially considering that now SBA is asking for $99 million more from borrowers and lenders.

In fact, Congress has *also* been overcharged since FY2010. In FY2010- FY2013, following the Great Recession, the 7(a) program received appropriations from Congress in order to cover the cost of the program, on top of fees charged to borrowers and lenders. Since those same years of congressional appropriations have shown significant downward re-estimates into the negative, just a few years of distance has shown that appropriations were not even necessary to cover the cost of the program.

A GAO report from March 1998 to the Senate Committee on Budget, titled "Greater Effort Needed to Overcome Persistent Cost Estimation Problems," highlighted a concern with consistently inaccurate subsidy calculations at SBA. This report discussed when SBA hired Price Waterhouse to conduct a diagnostic review of SBA's internal subsidy estimation process and states that, "This September 1997 study said that 'the credit subsidy process is not viewed as a way of assessing the future risk and costs of the program for management purposes. **Rather, the rate calculation is perceived [by SBA] to be a tool for gaming the congressional appropriations process**.'" SBA went on to insist this report was inaccurate, while Price Waterhouse continued to assert its accuracy. I'm sure that this Subcommittee and Congress join the industry in hoping that this is not currently an accurate representation of SBA's subsidy calculation process, but given the repeated downward reestimates that have overcharged small business borrowers, lenders, and also Congress, the subsidy model, methodology, and assumptions deserve a closer look.

Programmatic Improvements Should Factor Into the Subsidy Calculation

Further, I am concerned that the model fails to take into account significant programmatic changes. The successful passage of the *Small Business 7(a) Lending Oversight Reform Act of 2018* lead by this Committee and its Senate counterparts improved SBA's oversight capabilities and provided changes to the program to ensure lenders stay between the lines. These changes do not seem to factor into the Administration's view of the program in the FY20 7(a) subsidy calculation. SBA's Office of Capital Access has made significant improvements to ensure the program operates with integrity, including updating the agency's Standard Operating Procedure (SOP) to require that borrowers have more skin in the game—this change does not seem to matter when the Administration is assessing the future performance of this program in its FY20 budget request. When Congress increased the maximum loan size to $5 million from $2.5 million in the *Small Business Jobs Act of 2010,* lenders were able to make loans involving real estate and which contributed significantly more fees to the 7(a) subsidy account –two factors that provided more stability to the portfolio. These are just some examples of the countless programmatic changes to the

7(a) program over the past decade that SBA and OMB should factor in to the current subsidy calculation, and which do not seem to weigh heavily in current subsidy calculations.

As far back as July 1997, GAO provided testimony before this Committee titled "Credit Subsidy Estimates for the Sections 7(a) and 504 Business Loan Programs" that stated, "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**." There is a long-established track record of repeated over-estimations of cost, followed by an attempt on GAO's part to determine whether significant programmatic changes appropriately affected assumptions—these inquiries are just as relevant today.

Assumptions and Models Should Not Be Precluded from Congressional Oversight
I urge you to keep in mind throughout this conversation that SBA and OMB are simply making projections, basically educated guesses, about how loans that are made during FY20 might perform over the lifetime of those loans. Of course, this is no simple task and the model behind this subsidy calculation is complex, but it bears stressing that this subsidy calculation is really not a mathematical absolute based on a formula that cannot be challenged. Rather, modeling assumptions that were included, assumptions that were determined should not be included, and how these assumptions are weighted in the model must be reviewed and challenged—and it's appropriate to do so as members of this Committee and as the industry. Absent holding SBA and OMB accountable for correcting or amending the subsidy calculation, this Committee is going to have to carry out the results of a calculation that it seems no one, except SBA and OMB, understands. It hardly seems appropriate that the subsidy calculation's econometric assumptions and modeling should be shrouded in mystery. Yes, Congress gave the Executive branch authority to calculate subsidy costs, but Congress did not give *unfettered* authority to be carried out in a manner lacking in transparency or otherwise not responsive to Congressional oversight.

To this end, the findings in a March 2004 GAO report to the Senate and House Committees on Small Business, titled "Model for 7(a) Program Subsidy Had Reasonable Equations, but Inadequate Documentation Hampered External Reviews," point to a consistent inability to really discern whether the 7(a) subsidy model is most accurately estimating cost. Among the report's findings is that GAO and two other independent reviewers **<u>could not determine whether a bias existed in the model by systematically excluding variables to influence the subsidy rate in a particular direction</u>**. This is an alarming conclusion and one that should be looked into as it applies to the FY20 calculation. **The report goes on to state that SBA could not provide adequate documentation, a key internal control, to demonstrate the rationale and basis for key aspects of the model.** Even after SBA provided 800 pages of documentation to GAO, the report "concluded that this information would be of questionable or no usefulness in assessing SBA's development of the assumptions and selection of variables used in the modeling process." In addition, one of GAO's recommendations to OMB was not implemented, which was to update and improve OMB's Circular A-11 guidance which is either silent or unclear about the level of documentation necessary for credit subsidy model development. I urge this Subcommittee to look into these seemingly open-ended conclusions.

Impact of SBA's Proposed Fee Structure: Shrink Access to Capital
In the FY20 budget request, SBA indicates that its preferred method to cover the 7(a) program's cost is to restructure fees in the *Small Business Act,* raising costs for borrowers and lenders. The industry could understand this proposal *if* the portfolio was displaying a troubling pattern of poor performance in the portfolio. However, in this instance, there are no apparent performance issue that can be identified in the

portfolio, the budget's own data shows significant and repeated overcharging of borrowers for nearly the last decade, and SBA and OMB have yet to reveal the model's methodology and assumptions. Given these factors, SBA's proposed fee increases are nothing more than a tax on small business borrowers.

The consequence of SBA's proposals will be shrinking access to capital. Small business borrowers may be dissuaded from considering a SBA loan in the future, resulting in a reduction in access to capital. The benefits of having a program that is built on private-sector participants are numerous, but it also means there is a stark reality that the program needs to make sense financially for private-sector banks as well. If the program does not make financial sense for lenders, then they will participate less in the 7(a) program and access to capital will be further restricted.

In the aforementioned 1998 GAO report to the Senate Committee on Budget, we are reminded that we have been here before—OMB and SBA made a correction to their stated subsidy calculation mid-year for FY97 after noticing a "technical error" which GAO describes as a "large error" resulting in a significantly higher cost estimation than necessary. GAO goes on to state that by **"correcting this error…SBA was able to guarantee approximately $2.5 billion more in section 7(a) small business loans**. OMB and SBA officials acknowledged that better oversight and improved internal controls at both OMB and SBA are needed to prevent similar errors in the future." Over-estimations of cost are not just philosophical arguments—they have real consequences that translate to real dollars that otherwise could be available to this country's small business borrowers.

Without appropriately holding OMB and SBA accountable for their assumptions, something as arcane and bureaucratic as a flawed financial model for the 7(a) portfolio is essentially dictating the parameters of access to capital, rather than allowing Congress and the *Small Business Act* to exercise that authority.

Thank you for holding this hearing and I appreciate the opportunity to testify before this Subcommittee. I hope that my experience in the industry and my perspective on this incredibly detailed, technical issue sheds some light on the very real way that subsidy calculations and portfolio accounting can impact the level to which the 7(a) industry will be able to provide access to capital in the years ahead. I look forward to your questions.