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SMALL BUSINESS ADMINISTRATION: IS THE 7(a) PROGRAM ACHIEVING MEASURABLE OUTCOMES?

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, FEDERAL SERVICES, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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THURSDAY, NOVEMBER 1, 2007

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, FEDERAL SERVICES,
AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:05 p.m., in Room SD–342, Dirksen Senate Office Building, Hon. Thomas R. Carper, Chairman of the Subcommittee, presiding.

Present: Senators Carper and Coburn.

OPENING STATEMENT OF SENATOR CARPER

Senator CARPER. The hearing will come to order. Welcome one and all.

I am pleased to see all of our witnesses. I am especially pleased to see William B. Shear, who I once tried to introduce at another hearing as the one and only Billy Shear. The hearing was canceled. We had to stop the hearing because we then needed unanimous consent on the Senate floor to have Committee hearings that day and so we had to postpone it. It is going to be a pleasure introducing you today, and we are all glad that you are here.

I especially want to say thanks to Dr. Coburn for suggesting that we return to this issue. As it turned out, it is one that a fair amount of work has been done, is being done, and legislation even introduced, we just learned today, that further attempts to address some of these issues.

I am not sure who it was, I think it was Vince Lombardi—at least I always attribute it to him—who used to say—or the famous football coach of the Green Bay Packers—who used to say, “Unless you are keeping score, you are just practicing.” I have used that quote at a couple of hearings before and I think it certainly applies today.

I approach this hearing—I am happy we are having it. I talked to one member of our staff who didn’t get all juiced up about this particular hearing. I love this issue as a recovering governor. One of the things I focused on for 8 years was economic development, job creation, and job retention. Part of the ability of companies to get started, to be successful, to grow, to provide jobs, to provide employment opportunity, and give back to the community, was access to capital. So this is something that I have thought a little bit about and am very much interested in.

Part of what we want to do is just if it isn't perfect, make it better. We have a program, the 7(a) program, that is, I think, a pretty good program, not perfect. There are some ways we could make it better and we hope to maybe walk out of here with some ways to do just that.

People measure success in different ways. I believe this program has been successful. If you look at some of the testimony here, I think there are about 100,000 loans that have been made. Some $14 billion were guaranteed through the program just this last year alone, a lot of money. If I wanted to, I could spend a whole lot of time here in my statement reading through some of the 7(a) success stories that we have seen in Delaware, just that I literally saw last week and around the country over the years.

But unfortunately, as we will all hear today, we don't always know how all the businesses receiving these 7(a) loans fared. If we look at the default rate for the program, it is clear that most succeed, but there are certainly some that do not.

In order for the Small Business Administration and the lending community to better do their jobs, we probably need more information on the many successes and occasional failures among the 7(a) loan recipients. This information will tell us a good deal more than we know now about the effectiveness of the program. It will also help us to learn from our mistakes.

It is my hope that with better performance data on the 7(a) program, something I believe that all of our witnesses agree is needed, and I know one of our witnesses is not convinced we actually need the program, and we welcome that input, as well, but I think all the witnesses, in reading through your testimony, agree that we don't do an especially good job—we measure inputs pretty well, but we don't necessarily measure outputs very well. I always like to say, when I talk to people about whatever they are doing in life, I say, how do you measure success? I think that is a great question to ask with respect to this program.

So it is my hope that with better performance data on the 7(a) program, something that I believe all of our witnesses here today think is needed, we can better target loans to those businesses that need help and better ensure that what we are doing here is in their interest, and even more importantly, in the taxpayers' interest.

I will just close by noting that I think that government does have a role in this area. When I was governor, one of the things we did, we looked at Delaware's economy, and we are blessed with big companies, big, successful companies, a lot of big financial institutions, big chemical companies, science companies like DuPont and Hercules and others, auto assembly plants and so forth. One of the areas we are not especially strong in is new start-up for new businesses and job creation that flows out of those new businesses.

One of the things that we did in my little State was we put Small Business Development Centers in all of our counties, storefronts where people could walk into, find out how to get it incorporated, how to develop a business plan, a marketing plan, access to capital issues, all kinds of stuff like that.

We also created with a partnership with the banks something called Capital Access, which reminds me a little bit of this program but it is a bit different. When businesses would want to go to a bank for a loan, they would just say they wanted to borrow, let us say $10,000. They put a very small fraction, a small percentage of the loan into a reserve fund. I think the bank would have to put a small portion into a reserve fund. The idea was the reserve fund would grow, and if we ever had one of the loans go bad, then there was the money to make good on the loan. So this is something that we have thought a whole lot about and worked on, and that is providing access to capital.

I look forward to this hearing. I am delighted, Dr. Coburn, that you suggested it to bring us together and let us get the show on the road. You are recognized, my friend.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. Well, thank you. I appreciate Senator Carper agreeing to have this hearing. This isn't about eliminating the SBA program but it has everything to do with making sure the SBA program operates within the law, and today I see that it doesn't follow GPRA. It doesn't use the alternative credit or credit elsewhere formulas properly. And in terms of measurement, it doesn't measure outcomes, it measures outputs, and outputs are not outcomes.

The GAO spent a year looking at this and here is a quote from their statement. "All of the 7(a) program's performance indicators are output measures." What that means is we are measuring how much we are sending out the door, but we are not measuring what the effects of what we send out the door.

The thing I am having trouble with is either we don't want to measure it because we already know what the answer will be, or we just blindly don't want to manage in a way that helps guide us, and that is not to question anybody's motive. I am not trying to do that. But I am convinced after reading the GAO's report, and I have tons of questions today for both GAO and the SBA, is how is it that we are not following GPRA? How is it that we are not using credit elsewhere and we are not measuring it and don't have the tools to measure it to comply with the law? It is the law. It is not what Senator Coburn wants or Senator Carper wants, it is the law. And how do we know whether or not we are having an impact other than the amount of money going out of the door?

The other thing that I am concerned about is that the focus is on how much money we can move out the door, not on how many actual jobs are created, how many small businesses new capital formation, and whether or not those new jobs or that new capital formation could have been accomplished outside of the 7(a) program.

So I think there are a lot of questions. I appreciate so much that the GAO was so thorough in what they do. They know the law and they are an honest broker. They are not partisan, and I think we can trust where to ask the questions. That is what this hearing is about, is where to ask the questions and to find out what we are going to get accomplished in terms of outcome measurement, what we are going to get accomplished in terms of following GPRA, and what we are going to get accomplished in terms of alternative credit availability in terms of qualifying for 7(a) loans.

So I appreciate everyone's attendance and their statement. I have a full statement I would like to enter into the record and I would ask unanimous consent for that.

Senator CARPER. Without objection.

Senator COBURN. And again, thank you all for being here.

Senator CARPER. All right. I am going to take just a moment and introduce our witnesses.

Our first witness today, made famous in an album released 40 years ago this year, "Sergeant Pepper," the one and only Billy Shear. I love it whenever he comes before us as a witness and it reminds me of my youth. But we are delighted that you are here. We are really appreciative of the work that GAO has done.

Senator COBURN. Were you at Woodstock?

Senator CARPER. No, I was in the Navy. I was in Southeast Asia.

Senator COBURN. You were tied up, as well.

Senator CARPER. Fortunately, I was not tied up with John McCain.

Dr. Shear is Director of Financial Markets and Community Investment at GAO. He has directed the work addressing the Small Business Administration, the Federal Housing Administration—I may have a question on FHA for you here, too, as we look toward reauthorization of FHA—the Rural Housing Service, and Community and Economic Development Programs. Dr. Shear received his Ph.D. in economics from the University of Chicago, formerly served on an adjunct basis as a lecturer in city and regional planning at the University of Pennsylvania, just north of where my family and I live in Wilmington.

Our next witness, and I am going to see if I get your name right, Hedgespeth?

Mr. HEDGESPETH. Hedgespeth.

Senator CARPER. Hedgespeth. I will practice that a couple of times. Thank you. He was appointed SBA's Director of Financial. Has anyone ever mispronounced your name?

Mr. HEDGESPETH. Oh, I wish I had a dollar for each time.

[Laughter.]

Senator CARPER. All right. He was appointed SBA's Director of Financial Assistance in the Office of Capital Access in May 2007. Mr. Hedgespeth is a former Secretary of Economic Affairs in Massachusetts and was the founder of the first bank-owned urban investment bank. Mr. Hedgespeth's work led to six consecutive outstanding Community Reinvestment Act ratings for his institution—congratulations—and to it receiving the Ron Brown Award for Corporate Social Responsibility. Before coming to the Small Business Administration, Mr. Hedgespeth served as CFO and Senior Vice President at the Structured Employment and Economic Development Company, called SEEDCO, where he has led the implementation of a financial accounting system and the creation of a new loan fund strategy.

I want to say Veronique de Rugy, is that right?

Ms. DE RUGY. [Nodding head.]

Senator CARPER. Welcome. We are delighted that you are here. I understand you are a Senior Research Fellow at the Mercatus Center at George Mason University. I understand that you were previously a Resident Fellow at the American Enterprise Institute, a policy analyst at the CATO Institute, and a research fellow at the Atlas Economic Research Foundation, and——

Ms. DE RUGY. I am trying them all.

Senator CARPER. Oh, good. And your research interests include the Federal budget, homeland security, tax competition and financial piracy issues—privacy issues—probably piracy issues, too. Ms. de Rugy earned an M.A. in economics from the University of Paris–Dauphine and a Ph.D. in economics from the University of Paris–Sorbonne.

And finally, we have Anthony Wilkinson. There is a name I can actually pronounce without a huge amount of problem. He is President and CEO of the National Association of Government Guaranteed Lenders, the only national trade association that represents the Small Business Administration 7(a) industry. Mr. Wilkinson has served on both the SBA's National Advisory Council and Investment Advisory Council. He also has served on the Small Business Advisory Council. And prior to joining his association, Mr. Wilkinson spent 13 years with Stillwater National Bank. Where is Stillwater National Bank?

Mr. WILKINSON. Stillwater, Oklahoma.

Senator CARPER. All right. Have you ever been there?

Senator COBURN. Sure.

Senator CARPER. Once or twice?

Senator COBURN. I graduated from there.

Senator CARPER. Okay. He served as Senior Vice President responsible for the bank's Small Business Administration lending activities. He is the past recipient of the Small Business Administration's National Financial Services Advocate of the Year Award.

With all those introductions under our belts, again, we are delighted that you are all here, appreciate your preparing for this important hearing, and we look forward to your testimony and to having the opportunity to ask questions once you have spoken.

Your whole statement will be included in the record, and if you can wrap it up in about 5 minutes, we are not going to keep a real tight clock on you, but about 5 minutes would be fine, and then we will finish up and then ask questions.

Mr. Shear, the one and only.

TESTIMONY OF WILLIAM B. SHEAR,[1] DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Mr. Chairman, Dr. Coburn, and Members of the Subcommittee, I am pleased to be here today to share perspectives with the Subcommittee as it considers the extent to which SBA's 7(a) program is achieving measurable outcomes.

The 7(a) program guarantees loans made by commercial lenders, mostly banks, to small businesses for working capital and other general business purposes. The program is intended to help these businesses obtain credit that they cannot secure at reasonable terms in a conventional lending market.

My testimony today is based on a report we issued in July that examines the 7(a) program. Specifically, my testimony addresses,

[1] The prepared statement of Mr. Shear appears in the Appendix on page 33.

first, the 7(a) program's purpose and the performance measures SBA uses to assess the program's results; second, evidence of any market constraints that may affect small business's access to credit in a conventional lending market; third, the segments of the small business funding market that are served by 7(a) loans and the segments that are served by conventional loans; and fourth, the 7(a) program's credit subsidy cost and the factors that may cause uncertainty about the program's costs for the Federal Government. In the interest of time, in this oral statement, I will summarize our results for the first three objectives.

First, as the program's underlying statutes and legislative history suggest, the loan program's purpose is to help small businesses obtain credit. The program's design reflects this legislative history, but the performance measures provide limited information about the impact of the loans on participating small businesses. The underlying statutes and legislative history of the program help establish the Federal Government's role in assisting and protecting the interests of small businesses, especially those with minority ownership.

The program's performance measures focus on indicators that are primarily output measures. For instance, they report on the number of loans approved and funded, but none of the measures look at outcomes such as how well firms do after receiving 7(a) loans. As a result, the current measures do not indicate how well the agency is meeting its statutory goal of helping small businesses succeed.

With respect to these findings, we made a recommendation to SBA. We recommended that SBA complete and expand its current work on evaluating the program's performance measures. As part of this effort, at a minimum, SBA should further utilize the loan performance information it already collects, including but not limited to defaults, prepayments, and the number of loans in good standing to better report how small businesses fare after they participate in the 7(a) program.

Second, we found evidence, while limited, from economic studies suggesting that some small businesses may face constraints in accessing credit because of imperfections such as credit rationing in a conventional lending market. The studies we identified that empirically looked for evidence of this constraint within the conventional U.S. lending market generally provided some evidence consistent with credit rationing. Some studies showed, for example, that lenders may lack the information needed to distinguish between creditworthy and not creditworthy borrowers, and this could ration credit by not providing loans to all creditworthy borrowers in small business lending.

Third, we compared the share of 7(a) loans that went to small businesses with certain characteristics to the share of conventional loans that went to such businesses. We found that a higher percentage of 7(a) than conventional loans went to minority-owned and start-up businesses. However, more similar percentages of 7(a) and conventional loans went to other segments of the small business lending market, such as women-owned firms and those located in distressed neighborhoods. These results may be useful to SBA as it considers how it administers the program, including how it oversees participating lenders.

Mr. Chairman, Dr. Coburn, this concludes my prepared statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee may have.

Senator CARPER. Thank you, Dr. Shear. Mr. Hedgespeth, you are recognized and please proceed.

TESTIMONY OF GRADY HEDGESPETH,[1] DIRECTOR OF FINANCIAL ASSISTANCE AND OFFICE OF CAPITAL ACCESS, U.S. SMALL BUSINESS ADMINISTRATION

Mr. HEDGESPETH. Thank you very much, Mr. Chairman, Chairman Carper, Ranking Member Coburn. Thank you for inviting me to testify about the Small Business Administration's flagship loan guarantee program, the 7(a) program. I appreciate the opportunity to respond to the Government Accountability Office's July 2007 report on the 7(a) guarantee program.[2]

My name is Grady Hedgespeth and I am the Director of the Financial Assistance and Office of Capital Access at the SBA, where I oversee $65 billion of the agency's loan programs. I joined the SBA in May of this year, bringing 30 years of public and private sector experience, including serving most recently as CFO and Senior Vice President at the Structured Employment and Economic Development Company (SEEDCO), following 20 years in banking and the financial services industry and a stint as the Secretary of Economic Affairs of Massachusetts. Based on my experience, I bring a unique knowledge of the lending industry to the SBA and the effect of the SBA programs in that industry.

The 7(a) loan program, guarantee program, was established by Congress in 1953 to provide small businesses with the necessary capital that they cannot obtain in the commercial lending market. To be eligible for an SBA guarantee, the borrower must be a for-profit small business located in the United States and be unable to obtain credit elsewhere.

It is important to note that the SBA does not directly make loans. Rather, the SBA works with commercial banks, guaranteeing between 50 percent and 85 percent of the loans. The precise amount of the loan guarantee depends on the size of the loan and the paperwork requirements associated with the application.

Analysis by the GAO finds that, when compared to non-7(a) loans, the SBA's 7(a) loans serve a greater percentage of women and minority-owned firms, and historically, these categories of entrepreneurs have faced more difficulty gaining access to capital. While the 7(a) program is not designed to provide a preference for historically underserved borrowers, the fact that they are receiving SBA assistance at greater proportions again demonstrates the program's importance in reaching underserved businesses.

Given the 7(a) program's success, it is also important to keep in mind what the program does not do. The 7(a) program is not intended to compete with the conventional lending market. Rather, the program supplements this market by providing incentives for

[1] The prepared statement of Mr. Hedgespeth appears in the Appendix on page 57.
[2] The GAO Report appears in the Appendix on page 90.

lenders to provide loans to firms that may not otherwise qualify for traditional lending products. For banks to obtain a 7(a) guarantee, they must apply this credit elsewhere standard and certify that they would not make the loan without the SBA guarantee.

According to the GAO report, there are a variety of reasons why small firms have trouble obtaining commercial loans and thus meet the standard. These factors include lack of information about the borrower, lack of a previous relationship with the borrower between the borrower and the lender, and lack of collateral, and I would also observe that from my personal experience, insufficient net operating income is a critical factor in this credit elsewhere test being met.

The SBA continues to work to ensure that the 7(a) program carefully administers taxpayer resources. In the fiscal year 2005, the SBA restructured the 7(a) program into a zero-subsidy program. This approach adds stability and independence to the program while ensuring that the lending process is not hampered by the appropriations shortfall, such as those that occurred in 2003 and 2004.

Aside from having a zero-subsidy rate, another safeguard for taxpayers is that the 7(a) program is not liable for the guarantee if the lender does not comply with the program requirements. In addition, SBA continues to streamline and automate its loan processing function to reduce administrative cost.

In order to measure our progress, SBA consistently collects and reviews data on the 7(a) loan program. While these measures provide useful data, we are also looking for new ways to better measure our work and identify areas of improvement. Therefore, SBA appreciates the GAO's recommendation that SBA establish additional performance measures specifically to evaluate the effectiveness of the firms in the 7(a) program.

To this end, the SBA commissioned a study from the Urban Institute to analyze the SBA loan programs and to determine the market for small business loans and whether SBA is serving that market. In brief, what we learned is that there are a substantial number of creditworthy businesses that cannot find financing through the commercial lending market, and of those businesses, the SBA is serving a substantial number.

We are encouraged by this data and we believe that it provides insights that allow us to further the Congressionally-mandated mission of the guarantee program.

In response, SBA is reviewing its performance measures to determine how best to measure outcomes in terms of the 7(a) loan program. Data is needed to be able to identify and measure the sustainability of small businesses receiving SBA loans and how the agency's loan programs benefit the small business economy. The agency is evaluating whether the data currently being collected provides adequate information to make these decisions. This review will assess past performance, test new methodologies that can assist in setting future benchmarks.

Specifically, SBA is trying to determine how best to measure the effect of SBA assistance on the firms that receive it. Understanding the agency's impact on the small businesses receiving SBA loans will allow us to further tailor our loan programs and the guarantee program to ensure the greatest value for the taxpayers while continuing to fill a key gap in the financial market that allows small businesses to grow.

I would again like to thank the Chairman and Ranking Member Coburn for the opportunity to testify, and of course I will welcome your questions. Thank you.

Senator CARPER. Mr. Hedgespeth, thank you very much for your testimony and we look forward to asking some questions here in a minute.

Dr. de Rugy, you are recognized and thank you for joining us.

TESTIMONY OF VERONIQUE DE RUGY,[1] SENIOR RESEARCH FELLOW, THE MERCATUS CENTER AT GEORGE MASON UNIVERSITY

Ms. DE RUGY. Chairman Carper, Ranking Member Coburn, Members of the Subcommittee, it is an honor to appear before you today to discuss whether the SBA's 7(a) loan program is achieving measurable outcomes.

I would like to commend this Subcommittee for recognizing that outcome measurement is a crucial part of judging the success of a program, particularly as I am sure that this Subcommittee understands that outcome measurement is only useful to the extent that it triggers consequences if the Subcommittee finds that the 7(a) loan program under-performs or is unnecessary.

Encouraging lending to small businesses is one of the primary purposes of the 7(a) loan program, which works on the underlying assumption that inefficiency in the capital market caused lenders to pass over a large number of small businesses that, if given loans, would generate untapped economic growth.

Is there, in fact, a market failure that justifies government intervention via the SBA? My work concludes that there is no significant failure of the private sector to allocate loans efficiently. The literature that does refer to a market failure that Mr. Shear mentioned is grounded in old research that doesn't take much under consideration the tremendous developments in information technology that have reduced the high cost of access information about small business creditworthiness. Lending relationships and credit scoring techniques have changed the face of small business lending. The result, says Dr. Chad Moutray, Chief Economist for the Office of Advocacy at the SBA, is a financial market that tends to efficiently allocate capital to small businesses.

Another way to assess the relevance of the 7(a) loans is to analyze its role in the market. If there is a serious need for these loans and if the SBA is doing a good job meeting these needs, then the SBA's lending share should be quite large. But looking at the flow of 7(a) loans, we find, first, the SBA is largely irrelevant in the capital market. In a given year, roughly one percent of small business loans are SBA loans. The private sector finances most loans without government guarantee.

Second, there is no shortage of firms or new start-ups in America. The data suggests that even if the 7(a) loan program did not

[1] The prepared statement of Ms. de Rugy appears in the Appendix on page 60.

exist, entrepreneurs would start new businesses at the same rate they do now.

Third, in 2004, 29 percent of 7(a) loans went to minority business owners, but SBA distributed loans to only 3 percent of all minority-owned firms that got loans that year. The same trend is true for women-owned firms.

I have been criticized for looking at small business lending as a whole. I am told that long-term borrowers are the real target that SBA hits upon, not every small business out there, but a company that needs long-term financing.

First, where in the SBA mission does it say that long-term borrowers and not small businesses as a whole are its target? Well, it is easier to redefine targets rather than address my charges. Even in SBA's artificially-defined market of long-term loans, the private sector provides 60 percent of such loans without the Federal guarantee.

Second, the literature on the topic indicates that the length of the loan doesn't really matter. A small business that wants a long-term loan will get a loan with shorter maturity and then get it renewed as many times as it takes to meet its long-term need. If conventional and SBA lending provide the same result, it does not matter if the loans are successive short-term ones or a single long-term loan. On the other hand, a fairness issue clearly arises.

To conclude, all of the evidence points in one direction. The 7(a) loan program is not having a significant positive effect on the market. To prove me wrong, SBA advocates should measure the performance of the 7(a) loans based on outcome. It should include an analysis of their effect on economic growth and a comparison of the benefits of the program to its long-term cost, all of its cost, whether it is oversight, default, all of its cost. What it should not include is a count of the number of jobs created. The mere creation of jobs is not an appropriate economic policy objective because you can add jobs to an economy, yet it creates no value.

Measuring the performance of SBA loans should also include looking at who are the true beneficiaries of the program. My research points at 10 of America's biggest banks, not small businesses.

Entrepreneurship is one thing that Americans definitely know how to do without the government's help. Small businesses are doing a great job and will continue to do so with or without the SBA. Thank you.

Senator CARPER. Thank you, Dr. de Rugy. Our final witnesses is Mr. Wilkinson. Mr. Wilkinson, you are recognized.

TESTIMONY OF ANTHONY R. WILKINSON,[1] PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Thank you, Mr. Chairman and Senator Coburn. I appreciate the opportunity to testify today. You do have my written testimony. I would like to include, if SBA has not already, a copy of the Urban Institute report on the 7(a) and 504 programs.

Senator CARPER. Without objection, it will be included.

[1] The prepared statement of Mr. Wilkinson appears in the Appendix on page 81.

Mr. WILKINSON. Thank you very much. I would like to state some facts about the 7(a) program, many of which are highlighted in the GAO report.

First, the SBA 7(a) and 504 programs annually provide the small businesses over 40 percent of their financing needs with maturities of 3 years or greater. This makes SBA the single largest provider of long-term credit to small business in this country.

Another fact is that SBA programs are not meant or designed to replace all other forms of credit to small business. From the Urban Institute report: one, they have a definition of the SBA market segment as small businesses that have a demand for a loan; two, met the credit elsewhere requirement; and three, were as creditworthy as other firms that receive small business loans.

It is simply incorrect to argue that the program is not doing its job or meeting a specific need. The examples of SBA's program successes are innumerable and range from small local companies like Eskimo Joe's, that Dr. Coburn knows well, to large conglomerates like Nike and Columbia Sportswear. Each of these companies is an example of SBA programs helping companies provide stable employment, improved technology, and national productivity.

Next, the small business capital market cannot be considered to be well-functioning as segments of creditworthy businesses are denied access to credit on reasonable terms and conditions. The SBA programs provide credit to minority-owned businesses at a rate that is three times that of conventional lending. This fact is supported by the GAO report and the recently published Urban Institute report. In addition, 25 percent of 7(a) loans went to small business start-ups, while the overall lending market served almost exclusively established firms. Also, 49 percent of 7(a) loans made in fiscal year 2006 went to geographic areas that SBA considered underserved by the conventional market.

Next, according to CBO and SBA, since the beginning of credit reform in 1992, borrowers and lenders have paid well over $1 billion more in fees than was required under the Federal Credit Reform Act. That Act assures that the taxpayer has no estimated liability for 7(a) loans.

With respect to the concern that 7(a) loans have an inordinately high default rate, it should be noted that according to the President's fiscal year 2007 budget submission, the repurchase rate on 7(a) loans is projected to be 6.96 percent for the entire life of the cohort, less a 52 percent recovery rate. The annual default rate for conventional loans is typically in a 0.25 to 0.5 percent range. While there appears to be a significant disparity between the repurchase rate and the conventional default rate, it should be noted that it is an inaccurate comparison. The 7(a) repurchase rate represents the life of the lending pool while the commercial default rate is for one year.

So to make an apples-to-apples comparison, the effective life of a 7(a) cohort is about 7 years, making the 7(a) annual loss rate, using the banker method, of less than 0.5 percent per year. This compares favorably to the conventional small business loss rate and is far better than the credit card loss rate that annually runs 4 percent or greater.

One frequently overlooked fact is that the program mandates that all lenders, whether they sell loans or not, are responsible for prudent loan making and prudent loan servicing. SBA's guarantee is a contingent guarantee, which means that if a lender fails to fully meet its responsibilities, SBA can and does reduce the amount of the guaranteed payment to lenders. Therefore, the very nature of the guarantee relationship serves to assure that lenders engage in quality lending.

Last, I would like to read the conclusion from the Urban Institute report, two short paragraphs. The SBA loan programs are designed to enable private lenders to make loans to creditworthy borrowers who would otherwise not be able to qualify for a loan. As a result, there should be differences in the type of borrowers and loan terms associated with SBA guaranteed and conventional small business loans. Our comparative analysis shows such differences.

Overall, loans under the 7(a) and 504 programs were more likely made to minority-owned, women-owned, and start-up businesses, firms that have historically faced capital gaps, as compared to conventional small business loans. Moreover, the average amounts for loans made under the 7(a) and 504 programs to these types of firms were substantially greater than conventional small business loans to such firms. These findings suggest that the 7(a) and 504 programs are being used by lenders in a manner that is consistent with SBA's objective of making credit available to firms that face a capital opportunity gap.

Mr. Chairman, that concludes my remarks and I would be happy to answer questions.

Senator CARPER. Good. Thank you very much, Mr. Wilkinson.

I think it was Harry Truman who used to say the only thing that is new in the world is the history we never learned. I want us just to go back to the beginning of this program, which I believe had its genesis in 1953, and I am not sure who to ask to respond, but just explain to us why the program was created, the 7(a) program, what purpose it sought to meet, and then just share with us some of the major changes that have occurred in the program, most recently, I think, in 2005, and I think legislation may have been introduced today by Senators Olympia Snowe and John Kerry that would make some further changes in the program.

If somebody can share with us a brief outline of those changes, I would appreciate that. But let us just have a little bit of a sketch going back. What was this program supposed to accomplish in 1953? How has it changed over the years, Dr. Shear?

Mr. SHEAR. Sure. Nineteen-fifty-three, when the Small Business Administration was developed, it had an overall mission of helping support the small business sector. So I will just start with that mission of the overall agency, and I think it is relevant to this hearing because some of the objectives, based on the legislative history, what we tend to focus on, let us say they kind of differ a little bit across the table here. I will put it that way. But the overall was to support small business and its role and its vibrancy in the national economy.

The 7(a) program, when it was created, the objectives are a little bit more specific. I am not quite sure exactly when the specific objectives that we are addressing in our report came into being, but it became more toward trying to serve borrowers that couldn't get credit at suitable terms elsewhere. So I think that has been around for a long time. I don't know if it goes back to 1953.

I will jump forward to more current history. In the 1990s, one thing that happened at SBA that was typical of Federal loan insurance and guarantee programs, and for that matter—and I will stick to those, was that for efficiency reasons and because of technology, government agencies started delegating authority to lenders to make decisions that the Federal Government used to make in terms of approving loans and the whole loan process.

Much of our work over the years, like through the 1990s, was looking at when SBA delegated this authority to lenders, it did not—it forgot the lender oversight part and it has been largely since 1998 that SBA has made inroads in terms of lender oversight. And I think it is relevant to this hearing because when you have the Federal Government at risk, it is important to make sure that the Federal Government's risk exposure is limited and also that the mission of the program, because they serve a public mission, and you have this delegated authority to lenders, is being followed.

Now, more recently, going into recently, it used to be what is called the subsidized program, that based on credit reform, which came in in the 1990s where you are in a world of estimates, and that is one of the other topics that is in our report—Mr. Wilkinson talked about it—is that starting in 2005, it went from a program with a positive subsidy to a program with a zero subsidy——

Senator CARPER. Starting when? Two-thousand-and-five?

Mr. SHEAR. Two-thousand-and-five was the first year of zero subsidy.

Mr. WILKINSON. That is correct.

Mr. SHEAR. Now, part of the question here is that it is probably going to change the dynamic of how SBA serves borrowers and even begs the question even further, how can SBA, when it changes the programs, when it introduces new elements of the program, which is how is it going to affect the borrowers that ultimately are going to be served? How are lenders going to react to that? And how is SBA going to measure how well it is serving its mission, specifically to serving borrowers that can't get credit elsewhere in the conventional market? So it is kind of a new paradigm with some of the new programs, with the zero subsidy, and the whole question of the credit elsewhere test becomes more important than it has been in the past.

I hope I didn't sound too much like a college professor.

[Laughter.]

Senator CARPER. Does anyone want to add or take away from that history?

Mr. WILKINSON. Well, fortunately, I can say that I have not been around since 1953. I have been active in the program since 1986 and I think Mr. Shear did a very nice job of explaining where this program has come from.

Loan volumes did not pick up in this program until the late 1980s and then into the 1990s when SBA embarked on what it called its quality lending era and really tried to clean up underwriting issues and the program has blossomed since then. And over the last 15 years or so, SBA every year seems to come up with a way to streamline loan processing, and they are getting better and better every year, and that has helped attract lenders to the program.

As Mr. Shear talked about being on appropriations, that was an annual fight to go get money that ultimately, as you look at the reestimates in the budget every year, we were fighting for money that we sent back to Treasury. Everybody finally figured that out and we have gone to a zero subsidy.

Senator CARPER. Was that in 2005?

Mr. WILKINSON. That would have been part of the omnibus appropriation bill that was signed into law in December 2004, so for fiscal year 2005——

Senator CARPER. All right.

Mr. WILKINSON. [continuing]. Was the first year we went to zero subsidy. Before that, we were subject to all kinds of program stops and program restrictions. We capped loan sizes, all kinds of things that forced lenders away from the program and left many borrowers where they could not get any financing at all. Since going to zero subsidy in December 2004, we have not had any stoppages or caps and we have been able to lend at the authorized level.

Senator CARPER. All right. How do you measure success? I asked something about whether it is a government program or something outside of government, a lot of times I will ask people, how do you measure success in what you are doing, and how do we measure success with respect to the 7(a) program, and how should we measure success?

Mr. HEDGESPETH. Well, we currently measure success—and I think this is a point we will agree to—in many ways in terms of measuring not outputs, but, in fact, the building block to outputs, that we measure things like new loans approved to start-up businesses, loans funded to start-up small businesses, the number of loans approved to existing small businesses, the number of loans approved to small businesses facing specific opportunity and competitive gaps, such as has been testified to as women-owned, minority-owned firms.

We also do track jobs and we track jobs with the firms our borrowers themselves reporting to the banks, some 300,000 of them since the program's inception on the jobs that they are adding as a result of the funding that SBA provided. In 2006—I am sorry, in 2007, that number was 206,600 jobs. This year, our numbers are going to come in somewhere around 300,000 for the fiscal year that just ended. That is substantial economic activity proving the success of this program.

Now, we have tried in the Urban Institute data study to stretch that out to what happens in successive years and those are measures that we are going to continue to look at to see that we can track small businesses. It is very difficult data to obtain and our consultant, the Urban Institute, had trouble in the process themselves. But we are committed to continue to try to track our firms.

Senator CARPER. All right. Let me just basically ask, and I would ask you to be brief in responding, but how should we measure success in this program? Mr. Hedgespeth has been good to run through a variety of—but how should we? Let me just start with Dr. Shear.

Mr. SHEAR. Okay, thank you. We recommended at a minimum that now that SBA has technologically, through Dun and Bradstreet, the ability to look at how well the borrowers are doing and how long they stay in business, at a minimum, you measure success by those borrowers that you are reaching. Are they successful at staying in business? Are they defaulting on their loans? Are they prepaying after a period of time, which could be a success of the program that you would say that these firms that have been helped have been able to kind of graduate to conventional credit? So at a minimum, we would look at that. Some of the other measures would probably require some reference to the conventional lending market, and I will stop my answer at that for now.

Senator CARPER. All right, thank you. Dr. de Rugy, how should they measure success? I realize that in your testimony that this is not a program that you are especially enamored with, but if we are going to have this program, how should we measure success?

Ms. DE RUGY. We certainly shouldn't measure it the way the SBA is measuring it. Everything I have heard is, in fact, a way to count something, but it is not counting success, like counting the number of jobs that were created in a given year. If we don't know what is happening the next year, it is not very useful.

What we need to know, considering what I understood to be the goal of the 7(a) loans, which is to give credit to people who are overlooked by commercial banks and who, in fact, could be creditworthy, or are creditworthy even though they don't look creditworthy, and to see how much economic growth—I mean, the reason why we want to give money to these people is because we are told they can generate economic growth, so that is what we need to measure. And it is really hard, but this is what outcome measuring is about. It is not just like looking at—there is one job created this given year and so we need to have first a much more dynamic perception of what is being created.

But more importantly, we need also to measure, to actually take this benefit of the program and measure it against the cost of the program, and that means the cost of the default, which now supposedly are covered by this zero-subsidy fee and the lender fee, but also the cost of the oversight of the program. We need to take under consideration what happens if the economy tanks, which is—I mean, I am in the United States because I believe this is a country where that will not happen, but if it does happen and all or a vast majority of SBA borrowers default at the same time, right at the moment where the Federal Government is going to have to pay a higher unemployment benefit and things like this, I mean, we need to take under consideration this cost. It is not only about measuring what has been spent, it is also about measuring it against what it cost.

Senator CARPER. Thank you. We can go back in time, I think, to 2001 where most people say the economy tanked pretty low.

Ms. DE RUGY. Yes.

Senator CARPER. It would be interesting to look back at the data and see what happened.

Ms. DE RUGY. Actually——

Senator CARPER. My time is expired and I am on Dr. Coburn's time, so let me just ask Mr. Wilkinson to respond and then I will give it to Dr. Coburn. Thank you.

Mr. WILKINSON. I think it would be helpful to know exactly what it is we are looking for, as well. I hear the term, what the effect is on economic growth. I am not quite sure what we are after. The SBA has all kinds of data. I know I can tell you today what our currency rate is, what our repurchase rate has been, what our loss rate has been going back in time. We know a lot of this information. Where we are supposed to operate in terms of inside that information, I have asked several times for, like what is a target delinquency rate? Some would argue that today we are already too low, that we are missing some borrowers that we should be helping.

But that said, one of the measurements of success for us as lenders is we have borrowers who are paying their loans on time, and the vast majority of 7(a) borrowers are paying their loans on time. And I can tell you another measurement of success for us would be the number of start-ups that we finance because we are able to use the SBA program that we simply cannot do under a conventional basis. So there are a whole bunch of start-up businesses that are out there today that would not be there if we did not have a program like the 7(a) to help them out.

Senator COBURN. Let me jump in on that for a second.

Senator CARPER. Yes, jump right in.

Senator COBURN. If they are creditworthy—under the law, they are supposed to be creditworthy—why can't you finance them? Is it that you choose not to or that you choose only if you have got a government guarantee to finance them? And if that is the only reason you are financing them, then you have violated the law in terms of creditworthiness. We have been talking about the wrong things here. The SBA program is very clear in what it is supposed to do and the measurement of outcomes, as the GAO has said, are not there.

You are talking about outcomes measurement if you are doing business in the SBA and the SBA is talking about how many loans they do and how fast they do them and how easy it is to process. That is not the outcomes that we are looking at and talking about in this hearing.

Mr. WILKINSON. What outcome are we looking for?

Senator COBURN. There is a Federal law. It is called GPRA, and it requires every agency—this agency has known about it for 15 years—to develop outcome measurements. Now, what the law says is we are to be creating through SBA loans to people who are creditworthy who are missed by conventional lenders. That is what the purpose of the SBA is. That is what the statute says. The statute also says under GPRA, which is the Government Performance and Results Act, is every agency will develop outcomes. There is no outcome that has been developed by SBA.

That is why we are having the hearing. It is not that we don't want to do SBA loans. It doesn't have anything to do with it. It has to do with you cannot manage what you don't measure, and if you measure something that is not an outcome but is just a performance indicator of how far you do outputs, you wouldn't loan money to any business in Oklahoma that was doing that because you would be saying they are measuring the wrong thing.

So the purpose of the hearing today, and I thank you for the history because I think it tells a whole lot of why we are not in compliance. We are not trying to shoot anybody here. We are trying to make sure every branch of the Federal Government and every agency understands that because of the tremendous impact of dollars that are going to be coming our way in terms of the baby boomers under entitlement spending, every agency has to be able to manage what it does well. The testimony from the GAO says that there is not one performance outcome measure that meets GPRA done at the SBA, and I don't think that—am I stretching that?

Mr. WILKINSON. Mr. Shear just said one of the performance measures he would like to see is how well borrowers are doing. What does that mean? I can tell you how current they are.

Senator COBURN. No. What it means, in light of what the goals of the program are, how well are we doing filling the need for those people who are creditworthy but yet can't get financed, and that is the goal. If you look, this is a real revealing chart in the testimony by GAO. It shows creditworthiness and then it shows versus comparable conventional credit and you see a shift towards a lower creditworthiness in SBA lending. But the law says and the intention of SBA is to loan money to people who are creditworthy who can't get conventional credit.

So what we are asking for, and the whole purpose for trying to have this hearing is to try to get SBA to say, yes, we don't have an outcome measurement that we are using every month in complying with the Government Results and Performance Act to say, here is how we can know what we are doing. What that measurement is, is we know we are loaning more money, we know maybe the performance rate on it is better. We know we are probably helping more people than what we were. But the purpose—what has to be measured is what is the sphere of people who are creditworthy who cannot get money. That is the goal. So you have to measure the results against that goal.

There is no question the SBA has done a good job of improving a lot of things inside SBA. They have done a good job. All the bankers in Oklahoma tell me that. That is not what I am trying to get to here today. I am trying to get us to a point where we are measuring so we know what we are doing within the confines and direction of what the SBA is supposed to be doing with its 7(a) loan program, and that is loaning to people who are creditworthy who cannot get loans.

Mr. WILKINSON. The default teste that we would use is if I am a borrower who could get conventional financing without the SBA guarantee, I would do so because I don't have to pay a SBA guarantee fee. If I can't get financing conventionally, then I would accept——

Senator COBURN. So then how do you explain the risk curve that is shown here by the GAO?

Mr. WILKINSON. I don't know—which page are you on?

Senator COBURN. It is page 29 of their report. What they do is compare the percentage of loans made based on creditworthiness.

Mr. HEDGESPETH. If I may, Dr. Coburn, the interesting thing about the way the GAO used that report and those statistics, I would actually agree with you to say that is justification that, in fact, we are serving that niche that is just beyond conventional financing but wouldn't qualify using regular bank tests. The GAO looks at that same data and says there is no difference between the SBA data and conventional lending data. So I would absolutely agree with you.

And what is important about that, and really to the heart of your question, how do you know you are meeting the credit elsewhere test and lending to creditworthy borrowers? Because the standard SBA term is longer than the conventional term, it actually makes more deals work. So you have a borrower—I mentioned in my testimony where net operating income is a critical measure of whether or not a loan is approved, and these are constraints that are put on banks by their regulators.

Senator COBURN. Okay. So here is a measurement. The law says the Small Business Act prohibits anyone from getting a 7(a) loan who can get credit from another source, right? That is the law. It is what it says. How does SBA make sure that provision is followed and that lenders are not giving loans to businesses who can get some credit somewhere else? Are there no businesses who have gotten a 7(a) loan this last year who don't have a credit elsewhere that they would have qualified? Where is the measurement on that?

Mr. HEDGESPETH. I agree that is something that we absolutely have tried to do and tried to measure within the Urban Institute study to establish a baseline——

Senator COBURN. But the Urban Institute study doesn't count. Under GPRA, you have to say what your outcome measurements are and then you have to report and perform on what those outcome measurements are. You can't just have a study and say, here is what the Urban Institute says. You have to, under the law, set that up.

When is SBA going to set up a set of outcome measurements that coincide with what SBA's legislative intent is and then manage it based on the measurement of those outcome measures?

Mr. HEDGESPETH. Well, again, I am somewhat the new kid on the block——

Senator COBURN. I know you are, and my frustration isn't with the SBA. My frustration is we know we have $250 billion of waste, fraud, abuse, or duplication just in the discretionary portion of the budget, and so I am working hard in every area at every level to make sure—not to go after agencies, just to say are you measuring and are you managing based on what you are measuring? Every bank does that. Every business does that. And we ought to have every aspect of the Federal Government doing that. And besides, it is the law and SBA has been in noncompliance for 15 years under GPRA.

Mr. HEDGESPETH. Well, I know that the Urban Institute study, the discussion of it started in 2003, and the intent of commissioning the study was to allow us to have a baseline so that we could, in fact, then look at which performance measures made sense. We had them investigate a number of different possible scenarios to try to see where we could have a methodology that is repeatable and where we can, in fact, put a goal for ourselves that you could hold us accountable for.

We absolutely are not resistant to that, and as Director of the Office of Financial Assistance, it is going to be my responsibility to help the agency think through this report and to establish measures that we can feel that we can be held accountable.

Senator COBURN. See, the question that somebody like Dr. de Rugy would ask is if you look at measuring credit elsewhere, if you are not looking at that, you don't know if the people in the market need the SBA or the banks need the SBA. You won't know. And so do we have the SBA as a program for banks or do we have the SBA as a program to truly meet that part of the capital need for creditworthy individuals who are passed over by the banks?

And what has happened, good steps have moved to try to change that. How do we measure credit elsewhere worthiness, and is that a performance measure, and how do you set, here is what we want it to be, here is what the law says the requirements of SBA loaning are, and how are we going to compare how we are doing every year to that?

It is not how much money we loan. The real deal is how much capital formation came out of a SBA loan? That is what the real deal is. And it is not jobs. It is how much long-term capital formation, how much innovation created capital came out of that. Jobs are a measure of that. But what we are really getting to is what do we do in terms of growing our economy in terms of capital formation, because that is the ultimate measure.

Does everybody in the lending community ascertain and certify—I know they certify, but do they actually do the work on credit elsewhere?

Mr. WILKINSON. Well, they have to certify on the application that they would not make that loan under the similar terms and conditions.

Senator COBURN. Okay. But does that mean credit elsewhere or just for that one lending institution? In other words, if we have one lending institution that——

Mr. WILKINSON. One lender couldn't certify what another lender might or might not do.

Senator COBURN. Okay. So we are really not talking about credit elsewhere. We are talking about credit at the one person that is applying for the SBA loan, which is the whole point. If you go back to what the statute says, it talks about you have to determine that there is no credit available elsewhere, not just at the one lending institution. The one lending institution has an obvious bias. They are going to get a loan to somebody that they otherwise wouldn't loan to without the SBA, right?

Mr. WILKINSON. So how many institutions should a small business be forced to go——

Senator COBURN. I don't know, but——

Mr. WILKINSON. [continuing]. To establish that fact?

Senator COBURN. That is the question that SBA should set up to establish whether it has met the goals of the legislation. That is the outcome measures. And how are we ever going to know if we are not looking at that?

I am not critical. I know a lot of positive—you listed lots of anecdotal evidence of companies in Oklahoma that have grown mightily because of an SBA loan. That does not prove the fact that they might not have gotten one somewhere else. They just didn't.

Mr. WILKINSON. Well, I can tell you as a lender, there are several that were not going to get any financing if it were not for the SBA.

Senator COBURN. Okay, and I don't dispute that, and I am not saying that anecdotally that doesn't say that. But where is the measurement of all those that are successful versus all those that aren't and what has been the overall impact in terms of capital formation? So we are asking the agency, there is a Federal law that says you have to do this. One, you are out of compliance on that. GAO says that. You all know you are out of compliance on GPRA and you have been, even though you got a PART score, which I talked to OMB, how did they get a PART score if they are out of compliance on GPRA, which that tells you that maybe the PART program has a hole in it, as well. Would you like to comment on that, Mr. Shear?

Mr. SHEAR. I really can't——

Senator COBURN. You don't want to——

Mr. SHEAR. [continuing]. Comment specifically. No, that is specifically about how PART assesses the SBA program and whether—I know that when PART goes in and takes a look generally at programs, it looks for performance measurement. But specifically, the PART assessment on SBA, I am just not equipped to react to it.

Senator COBURN. Okay.

Ms. DE RUGY. Can I ask a question?

Senator COBURN. Sure.

Ms. DE RUGY. In terms of measurement, I think—of the outcome, I think it is one thing to be able to prove that the people wouldn't be able to get credit elsewhere, but I think what is also very important is to prove that this person who really couldn't, that it was cost effective for taxpayers to take that risk with that person.

Senator COBURN. Well, that is fine, but if we do a performance, they are supposed to be creditworthy, right?

Mr. WILKINSON. Yes.

Ms. DE RUGY. But my question is—while I am listening to all this —what is the mechanism that makes a bank suddenly, because there is a guarantee, capable of assessing the creditworthiness of a person while they weren't before, because the theory, right, is that this person is going to be overlooked as uncreditworthy or not worth taking a risk, and that is an information problem. What explains that suddenly you are capable of making this assessment that this borrower is creditworthy? I am absolutely confused.

Senator COBURN. Well, no, the difference there would be is we believe that we will take this credit risk because we have got some help in sharing the risk of it.

Mr. WILKINSON. Correct.

Senator COBURN. I mean, that is the calculation.

Ms. DE RUGY. But then the question is not that we weren't able to identify that this person was creditworthy, so we were before but we were not willing to take that risk.

Senator COBURN. The difference, and here is the difference, and maybe Director Hedgespeth can comment on it. Sometimes banks will take a risk but at an interest rate that kills the viability of the project. So that is where the calculation comes in, is at 12 percent when the prime rate is 6 percent, is it a viable business loan, versus at a rate of 9 percent when the prime rate is 6 percent with a government guarantee, you now have something that is capable.

So you raise a real question about what do we mean by creditworthy. Creditworthiness changes depending on the risk and the loan rate in terms of payout and carrying the interest. Can you carry this at 12 percent? No. But if you got an SBA loan, you can carry it at 9 percent, and the bank is ready to move you down. That is why we see so much go into it, because the mix of the payment goes down and makes it affordable. So I am not having any real problems with that.

I just want to get back. Does the SBA under your new Director have plans to put outcome, not output, outcome measures in at the levels for performance for 7(a)?

Mr. HEDGESPETH. I absolutely hope that during my tenure we are going to absolutely do that. The Urban Institute study is something we want to digest and look at the pieces that make sense in terms of having a repeatable, sound methodology that will give you, as well as the rest of the Members of Congress, a confidence that we have an outcome measure that is not subject to misinterpretation or manipulation, as is required by the PART, and that gets to the heart and soul of what our mission is. That is absolutely our desire.

Senator COBURN. As I look at the Urban Institute study and read that, I think what it shows is you are reaching your intended market. I don't think there is any question about it.

Mr. HEDGESPETH. Thank you.

Senator COBURN. But what it doesn't say is whether or not you are actually having a positive impact. There is no assessment in that Institute study on a positive impact, especially if you use it in terms of long-term capital formation, and that has to be our goal. And it is going to take creative people in your agency to say, and good economists to say, how are we going to measure whether or not this is really having an impact? There is no question in isolated instances we have a tremendously positive impact on long-term capital formation, but how is the program doing as a whole?

And that is our job up here, is to look at programs and make sure we have performance measures and outcome measures so that did we accomplish what we intended to accomplish when we put the American citizens at risk. I mean, that is what it is really about.

Over what period of time should the SBA be required to come back and have outcome measures?

Mr. HEDGESPETH. I am not sure I have a good or adequate response because we want to make sure that we have both measures that work and that you will be comfortable with, and also knowing that it took us since 2003 just to get this first baseline, I don't think waiting another 4 years is going to be acceptable to you.

Senator COBURN. No, sir, it is not.

Mr. HEDGESPETH. And so that is something that I would hope that you would allow us to respond more fully in follow-up remarks to this Subcommittee as we have had a chance to digest it.

Senator COBURN. Fine. And, see, I don't want us to have to have another Subcommittee hearing on this. What I would like is for us to have an agreement that the SBA is going to, like on an every 3-month basis, give Senator Carper and I, here is where we are, here is where we are going, here is what our goal is, and here is—in other words, put some performance measures on outcomes on getting to that. Design it, put the metrics on it, and say here is where we are going and here is how we are doing.

Mr. HEDGESPETH. Well, I think you know this Administrator is very fond of metrics that hold the agency accountable and that seems totally within the spirit of his leadership.

Senator COBURN. Thank you, and I have gone way over my time. Thank you, Mr. Chairman.

Senator CARPER. Mr. Wilkinson, talk to us, if you will, about some of the things that your members working through the 7(a) program are doing to help business. Just give us some examples.

Mr. WILKINSON. Well, again, we are lending it to new business start-ups and to early stage companies at a far greater rate than the conventional market is, so we are——

Senator CARPER. Quantify that for us, if you will.

Mr. WILKINSON. Quantify that?

Senator CARPER. Yes.

Mr. WILKINSON. Minority lending is about three times greater in the 7(a) program than it is in the conventional market. About 25 to 35 percent of our 7(a) loans are going to new business start-ups, and in the conventional market, that is almost non-existent. A very small percentage of conventional lending goes to a new business start-up and SBA uses new business start-up to mean a brand new business up to 2 years, so a very early stage company.

So we are helping the youngest firms get off the ground, a wide variety of industries, from service to retail, you name it, we will do it. And the SBA guarantee provides that extra credit enhancement that allows a lender to make a deal, and we think we have done a fabulous job. We think we are making all kinds of loans to small businesses that are generating jobs and creating capital formation and we welcome the opportunity to——

Senator COBURN. We just don't know that, though.

Mr. WILKINSON. Right, but we will welcome the opportunity to work with you and the SBA to come up with how we would measure that. I know SBA has Tax ID numbers on every business we finance, and I don't know whether they can access tax return records, etc.

Senator COBURN. No, they can't.

Mr. WILKINSON. But let me just say, we are happy to work with you on coming up with outcome measurement.

Senator CARPER. Okay. Let me just ask those of you who run these 7(a) programs from the banking side, what do you offer that the conventional market cannot offer?

Mr. WILKINSON. A loan. Typically, they cannot find——

Senator CARPER. No. My guess is that folks can get a loan in a lot of cases, but the interest——

Mr. WILKINSON. Well, sometimes what——

Senator CARPER. [continuing]. And my guess is——

Mr. WILKINSON. The other part of that answer would be we would finance a long-term asset with a long-term loan as opposed to making a borrower come back every 30 days and renew a loan. And for those of us that have lived through the 1980s in Oklahoma, we know a lot of small businesses got clipped because they had loans with maturities, loans that did not match the term of their asset, and so even though they had a long-term asset, they had a short-term loan and they couldn't get it renewed by any lender in the State. What the SBA program does is finance a long-term asset appropriately with a long-term loan.

Senator CARPER. Okay. Dr. de Rugy argued in her testimony at one point that many small businesses, including some who receive these 7(a) loans, I presume, have the ability to obtain credit really from conventional lenders. She mentions credit cards as one option.

As an aside, we have a new recycling program in the City of Wilmington, curbside recycling. We put all the recyclables into a single stream. Containers are picked up every week. They are actually picked up and the folks who do the pickup who used to just pick up trash to go to the landfill, now once a week they pick up the recyclables. They have device barcoding. They measure how much weight is in everybody's can, if you will, and barrel and they credit back to the individual residents points, something like a frequent flyer system, and you earn points which can be used for restaurant discounts, theater tickets, all kinds of stuff. It is actually a very clever program. The folks who actually collect the recyclables sell them and actually make money now with better prices for commodities.

But the guy who started the part of the business where they do the incentives for folks to recycle, he actually started his business with a bunch of credit cards and that is how he got started. It is interesting. I have talked to any number of entrepreneurs who got started and get all these credit card applications in the mail. Most people just throw them away or shred them, and some people save them and they use them, as you know, to start small businesses.

But Dr. de Rugy mentioned credit cards as one option. She also says that potential borrowers might have better luck over time if they build a relationship with their bank, and I would just ask for our other three witnesses, what are your thoughts with respect to that argument? What steps does the Small Business Administration and lenders that it works with take to make sure that businesses that truly don't need 7(a) loans don't get them?

Mr. SHEAR. Grady is looking at me. I will start.

[Laughter.]

One of the most, if you just go back to what we cite in the paper, Stigletz and Weiss which deals with what economists call asymmetric information, lack of information in the marketplace that might cause the market imperfections, lack of credit, it would be start-up businesses. It is probably one of the most logical places to look first if you want to have a credit guarantee program such as this.

But one of the reasons to kind of follow how well do those businesses do and what is the track record here is the question of whether businesses are kind of graduating when you would expect them to rather than them using the loans as like bridge loans and things like that. So some of it is just looking at the portfolio.

But one of the important things of credit elsewhere here is coming up with a working definition. Over all the years we have been looking at lender oversight issues, we have failed to see a really transparent credit elsewhere test, ever since going back to the early 1990s when they just said, come in with three lenders that you were denied a loan. Well, the world is a little more complicated now, so part of this is getting a focus. What is the expectation from lenders to make sure that it is credit that really supplements what is going on in the marketplace and trying to identify, what niche are you trying to serve and what evidence do you have that businesses might need that help and be able to graduate from that help over time versus businesses that might just say, well, the bank doesn't want to give them a 10-year loan with a 10-year maturity without a guarantee. Well, it might be what types of businesses can do well maybe with shorter-term credit.

So this is the type of evaluative approach that we are trying to get at, and if nothing else, we would like more transparency in how the credit elsewhere test is being applied.

Senator CARPER. Would anyone else want to respond to the comments on this point by Dr. de Rugy?

Mr. HEDGESPETH. I definitely would like to speak to this credit elsewhere and creditworthiness test. I mean, the very fact that the overall balance of the SBA portfolio pays back really pretty close to the overall pay-back rate of conventional lending strongly suggests that these are creditworthy borrowers.

Senator CARPER. What is the default rate, about 7 percent?

Mr. HEDGESPETH. That is the repurchase rate, but as the overall long-term default rate, at least right now, I have it running at 2.49 percent, but that is over the entire life of the loan, and as Tony testified, when you look at banks, they are doing it on a year-by-year basis. So either you accumulate their stuff up to a total or you take our total and work it back in terms of one-seventh of the amount that we have as a default rate and you get to be very close in terms of payout history.

But this issue of can you overcome the lack of willingness for a bank to lend under their conventional standards by somehow getting to know the bank better and to develop a relationship, I can tell you from my experience in Boston in helping to open up inner city markets to Bank Boston, to Bay Banks, to Fleet Boston, that they had a friend at the bank. They had me. But it took a partnership with the SBA to get our credit folks comfortable with making deals, and we did a number of them only because we were able to share that risk and apply less of the capital of the bank to underwrite the deal and to basically shore up the profitability because there was a belief that it would not pay as well.

And so SBA, I have seen in just institution after institution, becomes a way for the credit establishment of those banks to get comfortable with the kind of lending that conventional wisdom said they can't do.

When I was coming up in undergraduate school, Gary Becker, the economist from the University of Chicago, was very famous for saying——

Senator CARPER. Just yesterday or the day before he was awarded, I think, the Presidential Medal of Freedom.

Mr. HEDGESPETH. Very much so. He stated that in a market with perfect information, there can be no discrimination. But growing up in what you would consider, sir, a slum, I considered my neighborhood in Norfolk, Virginia, I can tell you, there was a lot of discrimination in lending institutions and I have spent my entire career trying to make Gary Becker right, and it has taken a lot of effort to move institutions beyond what they were comfortable in doing to move to new markets, to move to lending to more women-owned businesses, minority-owned businesses, inner city businesses. And the SBA was an absolutely critical partner in my 20 years of banking experience in doing that, and I did it at each one of my institutions profitably, but if I didn't have that partnership, we would have never gotten started.

Senator CARPER. All right. Mr. Wilkinson, did you want to say anything, and then I will yield to Dr. de Rugy.

Mr. WILKINSON. Well, I would just—small businesses that are relying on credit card debt, that is really an unstable source of financing. They really need to establish a relationship——

Senator CARPER. Pretty expensive, too.

Mr. WILKINSON. It is pretty expensive. But that said, 7(a) loans aren't cheap, either. The fees that we have to pay into SBA for the guarantee, if I am a borrower that can find financing without paying that fee, I would probably go that direction. So I think there is a built-in safeguard for businesses that could find conventional financing elsewhere not coming to the 7(a) program because they would be reluctant to pay the high fees. Some of our fees are as high as three-and-a-half, three-and-seven-eighths points on the loan. So it is pretty expensive financing on the highest-end borrowers.

Senator CARPER. Dr. de Rugy.

Ms. DE RUGY. I wanted to go back to this idea of the relevance of the 7(a) loans. I mean, I am confident that there are some borrowers out there who are, in fact, creditworthy and don't necessarily look to commercial lenders without the guarantee. However, I think we should not overlook the fact that the commercial banks are doing a tremendous job, and the reason why they are is because, in fact, they have a lot of those credit scorings and there is a relationship.

This is the reason why 53 years ago, I might not have been here saying that there wasn't a need for the SBA lending programs because, in fact, we didn't have all these ways to create relationships and to lower the cost to have access to information. Now we do, and when we look at what commercial banks are doing, they are a tremendous help to small businesses. In fact, they are so much so that according to the GAO report with the latest data, the 7(a) loans only represent 1.3 percent of all loans to small businesses, and I think this should not be overlooked. I mean, I think it is a very important point.

In the same way, I am amazed to hear some of the members of the panel say that without the 7(a) loan, there wouldn't be any start-ups in the United States. I think we are losing track of what we are talking about. Are we actually saying here that without the 7(a) loan, there would be no business starting? No. There is no way we can be saying that. In fact, the data that I looked at, and granted it was for fiscal year 2004, says exactly the opposite. In fact, 7(a) loans make a very small difference, if any difference at all. I think the scale of things is important.

My concern today, and I have looked a lot at the bank, I mean, we are talking about the fact that, yes, the bank issuing 7(a) loans is more expensive and that supposedly is a guarantee that borrowers would not accept to get 7(a) loans if they could get credit elsewhere. I am sorry. I am a woman with no experience in lending and borrowing and things like this and recently I had to actually go borrow money for my house, buy a car. I knew nothing about it. I had to rely on the honesty of the bank to tell me what I could do. It hasn't let me to acquire all this information, and I rely on the specialist that I go to deal with.

What guarantees me, because my research has actually led to show that banks, very few banks who are issuing 7(a) loans are making huge profits, and I want to state for the record that I am not at all against big banks making profits. It appears that it is actually a very profitable business for SBA lenders to issue loans for the one who can overcome the cost of actually jumping through the hoops issuing SBA loans. How do we know that these banks, in fact, are not steering away from conventional loans that would be less expensive or a small segment of borrowers and they are not steering them towards a loan that is way more profitable for them?

And this is the reason why if, honestly, if the car I just bought on Tuesday—I felt I was so hopeless, I had to rely on the people I dealt with. I had no choice. I didn't know very much. I have to assume that they informed me correctly, and the truth of the matter is I wouldn't know if they didn't. If it were so huge, maybe I would know. But when we are in this very gray area, how do you know? And if banks have such—a small amount of banks who are the biggest banks in America have such a financial incentive to actually steer you away, the fact that SBA loans have a higher rate and cost more is not to me a guarantee that we are issuing SBA loans to the right people.

Senator CARPER. Let me yield back to Dr. Coburn. Thank you.

Senator COBURN. I think, Mr. Chairman, it has been a great exchange. The point is, and the thing I would like to hear from the SBA is that we have got a time line on when we are going to have a definition of credit elsewhere and a significant test as a measurement on that and full compliance with GPRA. The problem with GPRA is there are no teeth. It is a great law, but if an agency like SBA chooses to ignore it, there are no consequences. Well, there are going to be in terms of the next appropriation bill, the next authorization bill, if we don't get there.

So what I will do is submit my questions for the record. I think we have had a great exchange. I thank everybody's input.

I had an experience, a very unsatisfactory experience with buying a business that had an SBA loan. If you are not normally used to dealing with SBA requirements and come in and take over a business that has an SBA loan, it is no fun, and I paid it off. I got out of there. I didn't want that over-regulation.

Final point I would make, as the GAO has said, if you don't have metrics to measure true outcomes, not outputs, you don't know whether or not you are accomplishing your stated purpose, and we all know that. We all use that in whatever we do, whether it is in a banking business or in a manufacturing business or at the GAO they actually measure their own output. I know, I have talked to their boss and they have metrics.

So the point is, is to move the SBA to get it to the point where it is compliant with the law and has good definitions so that they can create good metrics so we can really know the difference. And Dr. de Rugy may be right, may be wrong, but nobody knows until we start accurately measuring, and that was the whole point of me requesting the GAO study in the first place. Until we get metrics, we can have anecdotal stories, it can be great business for some, but we don't really know. We know that there are a lot of people that have benefited from it, including the banks, but we don't know if they might not have benefited without it.

So the whole goal is not to undermine SBA, it is to get the metrics so we can say, hey, atta boy. The "atta boys" we have now is on output, not outcomes, and there is no question—and let me compliment SBA. They have made great strides——

Senator CARPER. They have.

Senator COBURN. [continuing]. In terms of improving, and so that should not be lost in it.

Mr. Chairman, I thank you for having this hearing. I will submit some questions for the record. I would love a concurrence that we will get about an every 3-month update on what you are doing on this rather than having to make you come down here and testify and prepare for it.

Mr. HEDGESPETH. Yes, Senator.

Senator COBURN. All right. Thank you.

Senator CARPER. I don't know if anybody has anything else you want to briefly add. I have maybe one or two more questions and then we will wrap it up.

Mr. Wilkinson, I don't know if you want to go back and make a comment. One of the things that came to mind as Dr. de Rugy was talking about bank profitability, she doesn't have anything against big banks making money. Neither do I. But how profitable is this business to banks and are they making a bundle off of it?

Mr. WILKINSON. Well, each bank would have their own costs that they would have to deal with, but one of the issues that we in SBA are looking at now is the shrinking number of banks participating in the program. We are down to 2,500, I think, that are actively participating, and taking a look——

Senator CARPER. Out of about how many banks, 10,000?

Mr. WILKINSON. I think we are down in the 9,000s now, something like that. But, if a bank can't make a profit at this line of business, they are going to get out of it. It is a more difficult business because SBA has got a pile of rules and regulations that you need to know and understand, so there is a learning curve up front. But again, each bank would have their own cost issues.

I did want to comment on Ms. de Rugy's piece that the banking environment, at least the one that I am involved with, is a highly competitive marketplace, and if you try to drive a small business into a higher-priced loan than they can get, or they can get it cheaper somewhere else, they are going to the lowest-cost source as long as it makes sense in terms of the payment plan.

The other part of this is on the credit scoring she brought up. That is a classic example of credit elsewhere, in my opinion. Many of the numbers of loans today are approved by institutions who use the SBA Express product and they have internally a minimum credit score, so if you score, for instance, a 690, we will do you conventionally. At 680, you default down into the SBA product. I mean, they draw the line, this is what we do conventionally. If you can't get to that number, you have got to go down and get an SBA guarantee to enhance it.

And a significant number of the number of loans in the 7(a) program are done through credit scoring. So I think we are up 65, 70 percent of those numbers are done through the credit scoring process, that by definition, they can't qualify conventionally inside those institutions.

Mr. HEDGESPETH. I just have a couple of observations. When you look at what the SBA does in practice, the system that we have really in partnership with our lending institution partners kind of provides working capital, venture capital for the average Joe Businessperson in Main Street, America. They don't have big boutique private equity firms looking to put capital behind those businesses, yet it is the businesses that the SBA supports at the edge and the niche that we operate that supports a tremendous number of start-up businesses that create a lot of the jobs in this economy. In fact, small businesses create the majority of the jobs in this economy even though they are a very small percentage of it.

And we must be doing something right, because, Senator, the rest of the world is trying to copy our SBA model. We had the Deputy Administrator visit Africa recently. The Administrator was talking to the head of the EU who was looking at how do they create a program like this to basically spur their small business economy.

So I would say that the fact the rest of the world is looking at our model ought to give us pause about doing anything now that would curtail that.

Ms. DE RUGY. Can I add something to that?

Senator CARPER. Dr. de Rugy, please.

Ms. DE RUGY. Very quickly, there was actually a very interesting article in the *Economist* this week showing exactly that, in fact, the conclusion that the EU is starting to reach while looking at how entrepreneurship in the United States is is that where it works really well is where the government is not involved. I would be happy to actually submit that for the record.

Senator CARPER. All right. Thank you. As someone who was born and raised in France, you may want to tip those French people off to watch themselves as they get into this, or wade into this water.

Ms. DE RUGY. Yes.

Senator CARPER. Dr. Shear, is there anything you want to add?

Mr. SHEAR. Let me just make one point about the credit scoring. The private market develops mechanisms to address asymmetric information. I think the question here for this Subcommittee from a market standpoint is to what degree does the private market through credit scoring or through the role of venture capital firms kind of serve that niche, and I think that let us compare here, compare it with the hearing room two floors up when we start talking about housing finance.

The credit scoring models here that are used in the small business arena, they have been around for about a decade, but they are not at the level that you have in the small business lending market. So it still is—it is not quite the same type of issues we have in housing finance, and to compare with housing finance, no matter what you think of the different mortgage institutions, including the FHA, there is more of an evaluative approach to saying, what is the role of each of these entities, including the FHA, that has been there a long time. And in a sense, you could think about that might be relevant to looking at SBA now. It seems like SBA is moving in that direction and we certainly hope that they move in that direction.

Senator CARPER. All right. Thank you. Let me just wrap up here. From listening to the testimony of all of you, it sounds like the 7(a) program, the program that we have today is a good deal different than what we started out with many years ago and over time, it has improved, and it has improved as recently as 2005. For the last couple of years, it sounds, if I heard this right, that we no longer appropriate money to cover these loan defaults as they occur but the monies are actually collected during the course of business and running the program.

While it sounds like the percentage of small business loans that the 7(a) program comprises is fairly small, there are quite a few start-up businesses that rely on the 7(a), especially those that are looking for credit beyond a couple of months or even a year or so. But when you get into multiple years, it sounds like this is where a number of start-up businesses go for their financing for sort of, I call it intermediate terms, time.

Do I understand that the amount of loan, the percentage of the loan that the SBA guarantees is at least 50 percent and it can be as high as 85 percent?

Mr. HEDGESPETH. That is correct.

Senator CARPER. One of the questions I wanted to ask is how do you determine whether or not it is going to be 50 percent or 60 or 70 or 80 or 85 percent? How is that determination made? I presume it has something to do with risk, risk as it is perceived by the banks.

Mr. WILKINSON. The type of program and size of the loan.

Mr. HEDGESPETH. Yes.

Senator CARPER. I am sorry?

Mr. WILKINSON. The type of program used and size of loan. So if it is a loan made in the SBA Express program, that is where lenders can use their own forms. It comes with a 50 percent guarantee. The other guarantee percentages are based off the size of the loan. So if it is a loan of $150,000 or less, it could have an 85 percent guarantee, and if it is over $150,000, it would be a 75 percent guarantee up to a maximum loan size of $2 million.

Senator CARPER. All right. And I understand that the amount above prime that can be charged for these loans differs, as well. Can somebody tell me what the range is and how the determination is made as to what the——

Mr. WILKINSON. The interest rate is capped at prime plus two-and-three-quarters. The average interest rate, I believe, is running a little under prime plus two.

Senator CARPER. For some reason I was thinking it was more than two-and-three-quarters——

Mr. WILKINSON. On the smallest loans, there can be an interest add-on. So I believe it is $25,000 or less, you can go up to prime plus——

Mr. HEDGESPETH. Four.

Mr. WILKINSON. Prime plus four?

Senator CARPER. The rationale for that is because——

Mr. HEDGESPETH. Because smaller loans are more costly, more costly to book.

Senator CARPER. All right.

Mr. WILKINSON. Can I just comment briefly on the percentage of 7(a) loans? The banking industry is set up to do the 90-day financings, the 6-month financings. The Federal Reserve study shows that of the billions and billions of dollars that bankers make conventionally to small businesses, they are typically 150 days, on average, maturity. So banks get in there, they do the contract financing or the seasonal inventory financings. That is what banks are set for. They take their short-term deposit base and they are good at converting that into short-term lending.

What SBA does is the longer-term lending, financing the long-term assets that way. So I don't think it is fair to say that we are one percent of all small business financing, because that 7(a) is not supposed to be out there making the 90-day loans. That is not what we are about. Lenders need to figure out how to handle that conventionally. But what the 7(a) program does is address the long-term end of the market, and there we are a significant part of that market. The 7(a) by itself is a third of all long-term lending to small businesses. I mean, this is the number one source.

Senator CARPER. All right.

Ms. DE RUGY. One-third, so that means that the private sector provides two-thirds.

Mr. WILKINSON. Well, there would be some that can get financing conventionally.

Ms. DE RUGY. Can I ask a fairness question?

Senator CARPER. Please.

Ms. DE RUGY. I mean, this is the issue I have with the unlevel playing field that the SBA introduces. So if long-term financing is what you are after, this is what probably is going to really increase the probability of your business becoming successful. Why is it, then, that without much trouble, firms, small businesses cannot prove to a commercial bank that they would be creditworthy, or cannot prove what all the other borrowers are proving or passing the test for? Then they have access to a better term. They have access to something that is going to drastically improve the probability of them surviving. Why is it that——

Mr. WILKINSON. I think if you looked at the terms——

Ms. DE RUGY. [continuing]. Because in the first place, they were unable to get a conventional credit, why then would they be in the end really better off? It is really unfair to the people who actually pass the test of creditworthiness and it creates an unlevel playing field.

Senator CARPER. Any responses, please?

Mr. WILKINSON. Page 33 of the GAO report shows that the average conventional small business borrower is about borrowing at prime, so they are getting a better deal.

Senator CARPER. As opposed to a prime plus two or three?

Mr. WILKINSON. Correct.

Senator CARPER. Or four.

Ms. DE RUGY. But in the long-term, that doesn't address the long-term issue.

Mr. WILKINSON. I can tell you as a commercial lender, if there was a borrower who could qualify for a prime, we might be willing to do a shorter maturity with a longer amortization if they could qualify.

Ms. DE RUGY. But you are selling 7(a) loan as a great program because it actually provides firms with long-term loans which then increase the probability of them staying in business. So this is either an important factor or it is not, and what you are saying is that people can have access—who have access to commercial loans and have proven themselves and passed the test, they can't have access to that, and they don't. I mean, they usually don't. And there are more hurdles for them who are worthy in the first place and it is unfair.

Senator CARPER. All right. Well, I don't know if people would call this a lively hearing or not, but for Dr. Coburn and I, and I think for our staffs, it is a very interesting one, and for a couple of Senators who are very much interested in job creation and being able to build a strong economy, raise GDP, it is very pertinent and germane.

Can somebody tell me the nature of the legislation that I think was introduced today by Senator Snowe and by Senator Kerry?

Ms. LE. I can tell you.

Senator CARPER. I am going to ask you to just come up and maybe pull up a chair and tell us. Identify yourself for the record, please, your name and your affiliation.

Ms. LE. My name is Linda Le. I work for Senator Snowe on the Small Business Committee.

Senator CARPER. Oh, good. Welcome.

Ms. LE. Thank you. The legislation that was introduced today with Senator Snowe and Senator Kerry addresses quite a few recommendations in this GAO report and in a previous GAO report. Specifically, it tries to put in place measurements of economic outcomes. It looks at, or we ask for the number of jobs created, the number of employees, the assets the businesses create, their taxes paid, firms that go out of business, firms that prepay their loans, if the loans are in good standing, and then if they generate any new businesses that are related to the loan they originally took.

So that is part of what the legislation does. It has some other lender oversight factors, as well, but this was done in direct response to the GAO study. I also talked to Senator Coburn's staff about it and Ms. de Rugy and the banking as we tried to formulate what to track.

Senator CARPER. All right. Is it just a coincidence that the legislation was introduced today?

Ms. LE. No.

Senator CARPER. All right.

[Laughter.]

I will think about that. Well, I hope our staffs continue to talk with you, and who would be your counterpart with Senator Kerry?

Ms. LE. It is Kevin Wheeler.

Senator CARPER. Is Kevin here?

Ms. LE. Yes, she is.

Senator CARPER. Is your first name Kevin?

Ms. WHEELER. Yes, it is.

Senator CARPER. Hi, Kevin. I could barely see your lips moving when Linda Le was speaking up here, so that is good. Well, thank you both for coming and thank you for jumping up here and taking a mike, and Dr. de Rugy, thank you for sharing your seat and your microphone with Linda Le.

I think that pretty well takes us to the end of the line here. One last question of Mr. Hedgespeth. What is the commitment you have made on behalf of SBA to Dr. Coburn and me? Would you, in your own words, tell us what it is?

Mr. HEDGESPETH. As I understand our commitment, what I agreed to was a quarterly report to you on our progress with institutionalizing measures of our performance that are outcome-based.

Senator CARPER. I think that is the way I understood it, as well.

All right, folks. We will leave the hearing record open for a couple of weeks, give others a chance to maybe ask some questions in writing. If you could respond in a timely way, we would much appreciate it.

Thank you all for coming. Some of you have come across the ocean to participate in this hearing, it is great to spend this time with you and we appreciate your input.

We have come a long way with this program. It is a lot better than it used to be. There are obviously things we can do to make it better. If it isn't perfect, make it better, and let us just aim for perfection. Thank you all very much.

And with that, this hearing is adjourned.

[Whereupon, at 3:44 p.m., the Subcommittee was adjourned.]

APPENDIX

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EDT
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SMALL BUSINESS ADMINISTRATION

7(a) Loan Program Needs Additional Performance Measures

Statement of William B. Shear, Director
Financial Markets and Community Investment

GAO
Accountability * Integrity * Reliability

GAO-08-226T

November 2007

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Highlights

Highlights of GAO-08-226T, a testimony before the Subcommittee on Federal Financial Management, Government Information, Federal Services and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The Small Business Administration's (SBA) 7(a) program, initially established in 1953, provides loan guarantees to small businesses that cannot obtain credit in the conventional lending market. In fiscal year 2006, the program assisted more than 80,000 businesses with loan guarantees of nearly $14 billion. This testimony, based on a 2007 report, discusses (1) the 7(a) program's purpose and the performance measures SBA uses to assess the program's results; (2) evidence of any market constraints that may affect small businesses' access to credit in the conventional lending market; (3) the segments of the small business lending market that were served by 7(a) loans and the segments that were served by conventional loans; and (4) 7(a) program's credit subsidy costs and the factors that may cause uncertainty about these costs.

What GAO Recommends

In the report discussed in this testimony, GAO recommended that SBA complete and expand its work on evaluating 7(a)'s performance measures and that SBA use the loan performance information it collected, such as defaults rates, to better report how small businesses fare after they participate in the program. SBA concurred with the recommendation but disagreed with one comparison in a section of the report on credit scores of small businesses with 7(a) and conventional loans. GAO believes that its analysis provides a reasonable basis for comparing these credit scores.

www.gao.gov/cgi-bin/getrpt?GAO-08-226T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

SMALL BUSINESS ADMINISTRATION

7(a) Loan Program Needs Additional Performance Measures

What GAO Found

As the 7(a) program's underlying statutes and legislative history suggest, the loan program's purpose is intended to help small businesses obtain credit. The 7(a) program's design reflects this legislative history, but the program's performance measures provide limited information about the impact of the loans on participating small businesses. As a result, the current performance measures do not indicate how well SBA is meeting its strategic goal of helping small businesses succeed. The agency is currently undertaking efforts to develop additional, outcome-based performance measures for the 7(a) program, but agency officials said that it was not clear when they might be introduced or what they might measure.

Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections such as credit rationing, in the conventional lending market. Several studies GAO reviewed generally concluded that credit rationing was more likely to affect small businesses because lenders could face challenges in obtaining enough information on these businesses to assess their risk. However, the studies on credit rationing were limited, in part, because the literature relies on data from the early 1970s through the early 1990s, which do not account for recent trends in the small business lending market, such as the increasing use of credit scores. Though researchers have noted disparities in lending options among different races and genders, inconclusive evidence exists as to whether discrimination explains these differences.

7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. For example, from 2001 to 2004 25 percent of 7(a) loans went to small business start-ups compared to an estimated 5 percent of conventional loan. More similar percentages of 7(a) and conventional loans went to other market segments; 22 percent of 7(a) loans went to women-owned firms in comparison to an estimated 16 percent of conventional loans. The characteristics of 7(a) and conventional loans differed in several key respects: 7(a) loans typically were larger and more likely to have variable rates, longer maturities, and higher interest rates.

SBA's most recent reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 indicate that, in general, the long-term costs of these loans would be lower than initially estimated. SBA makes its best initial estimate of the 7(a) program's credit subsidy costs and revises the estimate annually as new information becomes available. In fiscal years 2005 and 2006, SBA estimated that the credit subsidy cost of the 7(a) program would be equal to zero—that is, the program would no longer require annual appropriations of budget authority—by, in part, adjusting fees paid by lenders. However, the most recent reestimates, including those made since 2005, may change because of the inherent uncertainties of forecasting subsidy costs and the influence of economic conditions such as interest rates on several factors, including loan defaults and prepayment rates.

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to be here today to discuss the Small Business Administration's (SBA) 7(a) loan program. Initially established in 1953, the 7(a) program guarantees loans made by commercial lenders—mostly banks—to small businesses for working capital and other general business purposes.[1] As the agency's largest loan program for small businesses, the 7(a) program is intended to help these businesses obtain credit that they cannot secure in the conventional lending market. For example, because they may lack the financial and other information that larger, more established firms can provide, some small businesses may be unable to obtain credit from conventional lenders. The guarantee provided through the 7(a) program assures lenders that they will receive an agreed-upon portion (generally between 50 percent and 85 percent) of the outstanding balance if a borrower defaults on a loan. Because the guarantee covers a portion of the outstanding amount, lenders and SBA share some of the risk associated with a potential default, decreasing the lender's risk and potentially making make more credit available to small businesses. In fiscal year 2006, the 7(a) program assisted slightly more than 80,000 businesses by guaranteeing loans valued at nearly $14 billion.

In my testimony, I will discuss the findings from our recent report on the SBA's 7(a) loan program.[2] Specifically, my testimony addresses (1) the 7(a) program's purpose and the performance measures SBA uses to assess the program's results; (2) evidence of any market constraints that may affect small businesses' access to credit in the conventional lending market; (3) the segments of the small business lending market that are served by 7(a) loans and the segments that are served by conventional loans; and (4) the 7(a) program's credit subsidy costs and the factors that may cause uncertainty about the 7(a) program's cost to the federal government.

In conducting this work, we reviewed the program's underlying statutes and legislative history. We compared the measures that SBA uses to assess the performance of the 7(a) program to criteria that we developed for

[1]Section 7(a) of the Small Business Act, as amended, codified at 15 U.S.C. § 636(a); see also 13 C.F.R. Part 120. Although SBA has limited legislative authority to make direct loans to borrowers that are unable to obtain loans from conventional lenders, SBA has not received any funding for these programs since fiscal year 1996.

[2]GAO, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*, GAO-07-769 (Washington, D.C: July 13, 2007).

successful performance measures and interviewed SBA officials on the agency's efforts to improve its performance measures. In addition, we summarized peer-reviewed studies on market imperfections in the lending market. Relying on SBA data from 2001 through 2004 and on the Federal Reserve's 2003 Survey of Small Business Finances (SSBF), we compared characteristics and loan terms of 7(a) borrowers to those of small business borrowers.[3] Finally, we compared SBA's original credit subsidy cost estimates for fiscal years 1992 through 2006 to SBA's current reestimates, (as reported in the fiscal year 2008 Federal Credit Supplement) and interviewed SBA officials about the differences.[4] We conducted our work in Washington, D.C., and Chicago between May 2006 and July 2007 in accordance with generally accepted government auditing standards.

In summary:

- As the 7(a) program's underlying statutes and legislative history suggest, the loan program's purpose is to help small businesses obtain credit. The 7(a) program's design reflects this legislative history, but the performance measures provide limited information about the impact of the loans on participating small businesses. The underlying statutes and legislative history of the 7(a) program help establish the federal government's role in assisting and protecting the interests of small businesses, especially those with minority ownership. The program's performance measures focus on indicators that are primarily output measures—for instance, they report on the number of loans approved and funded. But none of the measures looks at how well firms do after receiving 7(a) loans, so no information is available on outcomes. As a result, the current measures do not indicate how well the agency is meeting its strategic goal of helping small businesses succeed. The agency is currently undertaking efforts to develop additional, outcome-based performance measures for the 7(a) program, but agency officials said that it was not clear when these measures might be introduced or what they might measure.

[3]The Board of Governors of the Federal Reserve System's (Federal Reserve) SSBF is the best available data on loans made to small firms in the conventional lending market. Firms eligible for the SSBF include for-profit, nonagricultural, nondepository institutions, nongovernment businesses in operation in December 2003 and during the interview, that also had less than 500 employees. Information in the SSBF may include some loans that were guaranteed by the 7(a) loan program.

[4]Office of Management and Budget, Federal Credit Supplement, Budget of the U.S. Government, Fiscal Year 2008 (Washington, D.C.: Feb. 5, 2007).

- Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections such as credit rationing in the conventional lending market. Some studies showed, for example, that lenders might lack the information needed to distinguish between creditworthy and noncreditworthy borrowers and thus could "ration" credit by not providing loans to all creditworthy borrowers. Several studies we reviewed generally concluded that credit rationing was more likely to affect small businesses, because lenders could face challenges obtaining enough information on these businesses to assess their risk. However, the studies on credit rationing were limited because the researchers used different definitions of credit rationing and the literature relied on data from the early 1970s through the early 1990s. Data from this period does not account for recent trends in the small business lending market, such as the increasing use of credit scores, which may provide needed information and thus reduce credit rationing. Though studies we reviewed noted some disparities among borrowers with respect to race and gender in the conventional lending market, the studies did not offer conclusive evidence on the reasons for those differences.

- 7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans from 2001 to 2004. First, a higher percentage of 7(a) than conventional loans went to minority-owned and start-up businesses. For example, 28 percent of 7(a) loans compared with an estimated 9 percent of conventional loans went to minority-owned small businesses from 2001 through 2004. In addition, 25 percent of 7(a) loans went to small business start-ups, while the overall lending market served almost exclusively established firms (about 95 percent). However, more similar percentages of 7(a) and conventional loans went to other segments of the small business lending market, such as women-owned firms and those located in distressed neighborhoods. For example, 22 percent of 7(a) loans went to women-owned firms compared to an estimated 16 percent of conventional loans. Finally, the characteristics of 7(a) and conventional loans differed in several key respects. In particular, 7(a) loans typically were larger and more likely to have variable rates, longer maturities, and higher interest rates than conventional loans to small businesses.

- SBA's current reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 indicate that, in general, the long-term costs of these loans will be lower than initially estimated. Loan guarantee programs can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of the loan guarantees to the federal government. SBA makes its best initial estimate of the 7(a) program's credit subsidy costs and revises the estimate annually as new information becomes available. Starting in fiscal year 2005, SBA estimated that the credit subsidy cost of the 7(a) program would be equal to zero—that is, the program would no longer require annual appropriations of budget authority. To offset some of the costs of the program, such as default costs, SBA adjusted a fee paid annually by lenders that are based on the outstanding portion of the guaranteed loan so that the initial credit subsidy estimates would be zero (based on expected loan performance). However, the most recent reestimates, including those made since 2005, may change. Any changes would reflect the inherent uncertainties of forecasting subsidy costs and the influence of economic conditions such as interest rates on several factors, including loan defaults (which exert the most influence over projected costs) and prepayment rates. Unemployment, which related to the condition of the national economy, could also affect the credit subsidy cost—for instance, if unemployment rises above projected levels, loan defaults are likely to increase.

- Our recent report made a recommendation to SBA that was intended to help ensure that the 7(a) program was meeting its mission responsibility of helping small firms succeed through guaranteed loans. Specifically, we recommended that SBA complete and expand its current work on evaluating the program's performance measures and use the loan performance information it already collects, including defaults and prepayment rates, to better report how small businesses fare after they participate in the 7(a) program. SBA concurred with the recommendation but has not yet told us how the agency intends to implement it.

- Finally, SBA disagreed with our analysis that showed limited differences in credit scores between small businesses that accessed credit without SBA assistance and those that received 7(a) loans. We believe that our analysis of credit scores provides a reasonable basis for comparison. As SBA noted in its comments, we disclosed the limitations of the analysis and noted the need for some caution in interpreting the results. Taking into account these limitations, we believe that future comparisons of comparable credit score data for small business borrowers may provide SBA with a more conclusive picture of the relative riskiness of 7(a) and conventional borrowers, consistent with the intent of our recommendation.

Background

To be eligible for the 7(a) loan program, a business must be an operating for-profit small firm (according to SBA's size standards) located in the United States. To determine whether a business qualifies as small for the purposes of the 7(a) program, SBA uses size standards that it has established for each industry. SBA relies on the lenders that process and service 7(a) loans to ensure that borrowers meet the program's eligibility requirements.[5] In addition, lenders must certify that small businesses meet the "credit elsewhere" requirement. SBA does not extend credit to businesses if the financial strength of the individual owners or the firm itself is sufficient to provide or obtain all or part of the financing the firm needs or if the business can access conventional credit. To certify borrowers as having met the credit elsewhere requirement, lenders must first determine that the firm's owners are unable to provide the desired funds from their personal resources. Second, lenders must determine that the business cannot secure the desired credit for similar purposes and the same period of time on reasonable terms and conditions from nonfederal sources (lending institutions) without SBA assistance, taking into account the prevailing rates and terms in the community or locale where the firm conducts business.

According to SBA's fiscal year 2003-2008 Strategic Plan, the agency's mission is to maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters. SBA describes the 7(a) program as contributing to an agencywide goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs." As reported annually in SBA's Performance and Accountability Reports (PAR), the 7(a) program contributes to this strategic goal by fulfilling each of the following three long-term, agencywide objectives:

- increasing the positive impact of SBA assistance on the number and success of small business start-ups,
- maximizing the sustainability and growth of existing small businesses that receive SBA assistance, and

[5] Within the 7(a) program, there are several program delivery methods—regular 7(a), the certified lender program, the preferred lender program, SBAExpress, Community Express, Export Express, and Patriot Express. SBA provides final approval for loans made under the regular 7(a) program. Certified lenders must perform a thorough credit analysis on the loan application packages they submit to SBA that SBA can use to perform a credit review, shortening the loan processing time. Preferred lenders have delegated authority to make SBA-guaranteed loans, subject only to a brief eligibility review and assignment of a loan number by SBA. Lenders participating in SBAExpress, Community Express, Export Express, and Patriot Express also have delegated authority to make SBA-guaranteed loans.

- significantly increasing successful small business ownership within segments of society that face special competitive opportunity gaps.

Groups facing these special competitive opportunity gaps include those that SBA considers to own and control little productive capital and to have limited opportunities for small business ownership (such as African Americans, American Indians, Alaska Natives, Hispanics, Asians, and women) and those that are in certain rural or low-income areas. For each of its three long-term objectives, SBA collects and reports on the number of loans approved, the number of loans funded (i.e., money that was disbursed), and the number of firms assisted.

Loan guarantee programs can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of these programs—that is, the cost of the loan guarantee to the federal government. In recognizing the difficulty of estimating credit subsidy costs and acknowledging that the eventual cost of the program may deviate from initial estimates, FCRA requires agencies to make annual revisions (reestimates) of credit subsidy costs for each cohort of loans made during a given fiscal year using new information about loan performance, revised expectations for future economic conditions and loan performance, and improvements in cash flow projection methods. These reestimates represent additional costs or savings to the government and are recorded in the budget. FCRA provides that reestimates that increase subsidy costs (upward reestimates), when they occur, be funded separately with permanent indefinite budget authority.[6] In contrast, reestimates that reduce subsidy costs (downward reestimates) are credited to the Treasury and are unavailable to the agency. In addition, FCRA does not count administrative expenses against the appropriation for credit subsidy costs. Instead, administrative expenses are subject to separate appropriations and are recorded each year as they are paid, rather than as loans are originated.

[6]Permanent, indefinite budget authority is available as a result of previously enacted legislation (in this case, FCRA) and is available without further legislative action or until Congress affirmatively rescinds the authority. The amount of the budget authority is indefinite—that is, unspecified at the time of enactment—but becomes determinable at some future date (in this case, when reestimates are made).

The 7(a) Program's Policy Objectives Reflect Legislative History, but Its Performance Measures Do Not Gauge the Program's Impact on Participating Firms

The legislative basis for the 7(a) program recognizes that the conventional lending market is the principal source of financing for small businesses and that the loan assistance that SBA provides is intended to supplement rather than compete with that market. The design of the 7(a) program has SBA collaborating with the conventional market in identifying and supplying credit to small businesses in need of assistance. Specifically, we highlight three design features of the 7(a) program that help it address concerns identified in its legislative history. First, the loan guarantee, which plays the same role as collateral, limits the lender's risk in extending credit to a small firm. Second, the "credit elsewhere" requirement is intended to provide some assurance that guaranteed loans are offered only to firms that are unable to access credit on reasonable terms and conditions in the conventional lending market. Third, an active secondary market for the guaranteed portion of a 7(a) loan allows lenders to sell the guaranteed portion of the loan to investors, providing additional liquidity that lenders can use for additional loans.

Furthermore, numerous amendments to the Small Business Act and to the 7(a) program have laid the groundwork for broadening small business ownership among certain groups, including veterans, handicapped individuals, and women, as well as among persons from historically disadvantaged groups, such as African Americans, Hispanic Americans, Native Americans, and Asian Pacific Americans. The 7(a) program also includes provisions for extending financial assistance to small businesses that are located in urban or rural areas with high proportions of unemployed or low-income individuals or that are owned by low-income individuals. The program's legislative history highlights its role in, among other things, helping small businesses get started, allowing existing firms to expand, and enabling small businesses to develop foreign markets for their products and services.

All nine performance measures we reviewed provided information that related to the 7(a) loan program's core activity, which is to provide loan guarantees to small businesses. In particular, the indicators all provided the number of loans approved, loans funded, and firms assisted across the subgroups of small businesses the 7(a) program was intended to assist.

We have stated in earlier work that a clear relationship should exist between an agency's long-term strategic goals and its program's performance measures.[7] Outcome-based goals or measures showing a program's impact on those it serves should be included in an agency's performance plan whenever possible. However, all of the 7(a) program's performance measures are primarily output measures. SBA does not collect any outcome-based information that discusses how well firms are doing after receiving a 7(a) loan. Further, none of the measures link directly to SBA's long-term objectives. As a result, the performance measures do not fully support SBA's strategic goal of increasing the success of small businesses by "bridging competitive opportunity gaps facing entrepreneurs."

SBA officials have recognized the importance of developing performance measures that better assess the 7(a) program's impact on the small firms that receive the guaranteed loans. SBA is still awaiting a final report, originally expected sometime during the summer of 2007, from the Urban Institute, which has been contracted to undertake several evaluative studies of various SBA programs, including 7(a), that provide financial assistance to small businesses.

SBA officials explained that, for several reasons, no formal decision had yet been made about how the agency might alter or enhance the current set of performance measures to provide more outcome-based information related to the 7(a) program. The reasons given included the agency's reevaluation of its current strategic plan in response to requirements in the Government Performance and Results Act of 1993 that agencies reassess their strategic plans every 3 years, a relatively new administrator who may make changes to the agency's performance measures and goals, and the cost and legal constraints associated with the Urban Institute study. However, SBA already collects information showing how firms are faring after they obtain a guaranteed loan. In particular, SBA regularly collects information on how well participating firms are meeting their loan obligations. This information generally includes, among other things, the number of firms that have defaulted on or prepaid their loans—data that could serve as reasonable proxies for determining a firm's financial status. However, the agency primarily uses the data to estimate some of the costs associated with the program and for internal reporting purposes, such as monitoring participating lenders and analyzing its current loan portfolio.

[7] Some earlier work includes GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996); and GAO, *The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans*, GAO/GGD-10.1.120 (Washington, D.C.: April 1998).

Using this information to expand its performance measures could provide SBA and others with helpful information about the financial status of firms that have been assisted by the 7(a) program.

To better ensure that the 7(a) program is meeting its mission responsibility of helping small firms succeed through guaranteed loans, we recommended in our report that SBA complete and expand its current work on evaluating the 7(a) program's performance measures. As part of this effort, we indicated that, at a minimum, SBA should further utilize the loan performance information it already collects, including but not limited to defaults, prepayments, and number of loans in good standing, to better report how small businesses fare after they participate in the 7(a) program. In its written response, SBA concurred with our recommendation.

Limited Evidence Suggests That Certain Market Imperfections May Restrict Access to Credit for Some Small Businesses

We found limited information from economic studies that credit constraints such as credit rationing could have some effect on small businesses in the conventional lending market. Credit rationing, or denying loans to creditworthy individuals and firms, generally stems from lenders' uncertainty or lack of information regarding a borrower's ability to repay debt. Economic reasoning suggests that there exists an interest rate—that is, the price of a loan—beyond which banks will not lend, even though there may be creditworthy borrowers willing to accept a higher interest rate.[8] Because the market interest rate will not climb high enough to convince lenders to grant credit to these borrowers, these applicants will be unable to access credit and will also be left out of the lending market.[9] Of the studies we identified that empirically looked for evidence of this constraint within the conventional U.S. lending market, almost all provided some evidence consistent with credit rationing. For example, one study found evidence of credit rationing across all sizes of firms.[10] However, another study suggested that the effect of credit rationing on

[8]For more details on how economic theory predicts credit rationing, see J.E. Stiglitz and A. Weiss, "Credit Rationing in Markets with Imperfect Information," *The American Economic Review*, vol. 71, no.3 (1981).

[9]However, under certain circumstances, economic reasoning suggests that lack of information about certain types of borrowers could result in the opposite—an excess of credit. See D. DeMeza and D.C. Webb, "Too Much Investment: A Problem of Asymmetric Information," *The Quarterly Journal of Economics*, vol. 102, no. 2 (1987).

[10]S. J. Perez, "Testing for Credit Rationing: An Application of Disequilibrium Econometrics," *Journal of Macroeconomics*, vol. 20, no. 4 (1998).

small firms was likely small, and another study suggested that the impact on the national economy was not likely to be significant.[11]

Because the underlying reason for having been denied credit can be difficult to determine, true credit rationing is difficult to measure. In some studies we reviewed, we found that researchers used different definitions of credit rationing, and we determined that a broader definition was more likely to yield evidence of credit rationing than a narrower definition. For example, one study defined a firm facing credit rationing if it had been denied a loan or discouraged from applying for credit.[12] However, another study pointed out that firms could be denied credit for reasons other than credit rationing—for instance, for not being creditworthy.[13] Other studies we reviewed that studied small business lending found evidence of credit rationing by testing whether the circumstances of denial were consistent with a "credit rationing" explanation such as a lack of information. Two studies concluded that having a preexisting relationship with the lender had a positive effect on the borrower's chance of obtaining a loan.[14] The empirical evidence from another study suggested that lenders used information accumulated over the duration of a financial relationship with a borrower to define loan terms. [15] This study's results suggested that firms with longer relationships received more favorable terms—for instance, they were less likely to have to provide collateral. Because having a relationship with a borrower would lead to the lender's having more information, the positive effect of a preexisting relationship is consistent with the theory behind credit rationing.

[11]A. R. Levison and Kristen L. Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S.," *Small Business Economics*, vol. 14, no. 2 (2000); and A. N. Berger and G. F. Udell, "Some Evidence on the Empirical Significance of Credit Rationing," *The Journal of Political Economy*, vol. 100, no. 5 (1992).

[12]J. Berkowitz and M. J. White, "Bankruptcy and Small Firms' Access to Credit," *The RAND Journal of Economics*, vol. 35, no. 1 (2004).

[13]Levinson and Willard, "Do Firms Get the Financing They Want?"

[14]M. A. Petersen and R. G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *The Journal of Finance*, vol. 49, no. 1 (1994); and R. A. Cole, "The Importance of Relationships to the Availability of Credit," *Journal of Banking and Finance*, vol. 22 (1998).

[15]A. N. Berger and G. F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *The Journal of Business*, vol. 68, no. 3 (1995).

However, the studies we reviewed regarding credit rationing used data from the early 1970s through the early 1990s and thus did not account for several recent trends that may have impacted, either positively or negatively, the extent of credit rationing within the small business lending market. These trends include, for example, the increasing use of credit scores, changes to bankruptcy laws, and consolidation in the banking industry.

Discrimination on the basis of race or gender may also cause lenders to deny loans to potentially creditworthy firms. Discrimination would also constitute a market imperfection, because lenders would be denying credit for reasons other than interest rate or another risk associated with the borrower. A 2003 survey of small businesses conducted by the Federal Reserve examined differences in credit use among racial groups and between genders.[16] The survey found that 48 percent of small businesses owned by African Americans and women and 52 percent of those owned by Asians had some form of credit, while 61 percent of white- and Hispanic-owned businesses had some form of credit.[17] Studies have attempted to determine whether such disparities are due to discrimination, but the evidence from the studies we reviewed was inconclusive.

A Higher Percentage of 7(a) Loans Went to Certain Segments of the Small Business Lending Market, but Conventional Loans Were Widely Available

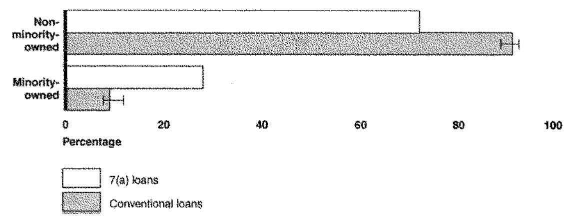
Certain segments of the small business lending market received a higher share of 7(a) loans than of conventional loans between 2001 to 2004, including minority-owned businesses and start-up firms. More than a quarter of 7(a) loans went to small businesses with minority ownership, compared with an estimated 9 percent of conventional loans (fig. 1). However, in absolute numbers many more conventional loans went to the segments of the small business lending market we could measure, including minority-owned small businesses, than loans with 7(a) guarantees.[18]

[16]T. L. Mach and J. D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin* Oct.: A167-A195 (2006).

[17]The survey question specifically asked respondents about having a credit line, loan, or capital lease.

[18]For example, we estimate that in 2004 approximately 62,000 outstanding 7(a) loans went to minority-owned firms, while there were more than 1.6 million outstanding loans to minority-owned small businesses from the conventional lending market.

Figure 1: Percentage of 7(a) and Conventional Loans by Minority Status of Ownership, 2001-2004

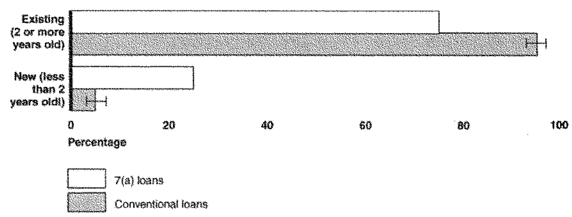


Source: GAO analysis of SBA and Federal Reserve Board of Governor's data.

Note: The brackets on the conventional loans represent confidence intervals. Because the data from SSBF are from a probability survey based on random selections, this sample is only one of a large number of samples that might have been drawn. Since each sample could have provided different estimates, we express our confidence in the precision of the particular results as a 95-percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. As a result, we are 95-percent confident that each of the confidence intervals will include the true values in the study population. Information on SBA 7(a) loans does not have confidence intervals, because we obtained data on all the loans SBA approved and disbursed from 2001 to 2004.

Compared with conventional loans, a higher percentage of 7(a) loans went to small new (that is, start-up) firms from 2001 through 2004 (fig. 2). Specifically, 25 percent of 7(a) loans went to small business start-ups, in contrast to an estimated 5 percent of conventional loans that went to newer small businesses over the same period.

Figure 2: Percentage of 7(a) and Conventional Loans by Status as a New Business, 2001-2004

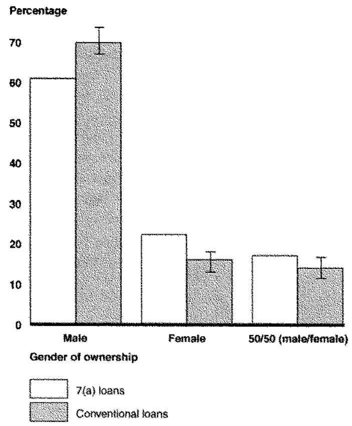


Source: GAO analysis of SBA and Federal Reserve Board of Governor's data

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

Only limited differences exist between the shares of 7(a) and conventional loans that went to other types of small businesses from 2001 through 2004. For example, 22 percent of all 7(a) loans went to small women-owned firms, compared with an estimated 16 percent of conventional loans that went to these firms. The percentages of loans going to firms owned equally by men and women were also similar—17 percent of 7(a) loans and an estimated 14 percent of conventional loans (fig. 3). However, these percentages are small compared with those for small firms headed by men, which captured most of the small business lending market from 2001 to 2004. These small businesses received 61 percent of 7(a) loans and an estimated 70 percent of conventional loans.

Figure 3: Percentage of 7(a) and Conventional Loans by Gender of Ownership, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

Similarly, relatively equal shares of 7(a) and conventional loans reached small businesses in economically distressed neighborhoods (i.e., zip code areas) from 2001 through 2004—14 percent of 7(a) loans and an estimated 10 percent of conventional loans.[19] SBA does not specifically report whether a firm uses its 7(a) loan in an economically distressed neighborhood but does track loans that go to firms located in areas it considers "underserved" by the conventional lending market.[20] SBA's own

[19]We defined distressed neighborhoods as zip code areas where at least 20 percent of the population had incomes below the national poverty line.

[20]These include the following federally defined areas: Historically Underutilized Business Zone, Empowerment Zone/Enterprise Community, low- and moderate-income census tract (median income of census tract is no greater than 80 percent of the associated metropolitan area or nonmetropolitan median income), or rural (as classified by the U.S. Census).

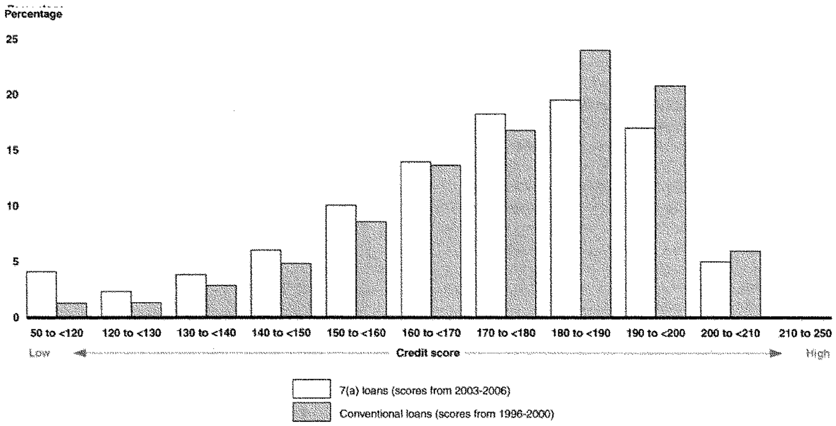
analysis found that 49 percent of 7(a) loans approved and disbursed in fiscal year 2006 went to these geographic areas.

A higher proportion of 7(a) loans (57 percent) went to smaller firms (that is, firms with up to five employees), compared with an estimated 42 percent of conventional loans. As the number of employees increased, differences in the proportions of 7(a) and conventional loans to firms with similar numbers of employees decreased. Also, similar proportions of 7(a) and conventional loans went to small businesses with different types of organizational structures and in different geographic locations.

Our analysis of information on the credit scores of small businesses that accessed credit without SBA assistance showed only limited differences between these credit scores and those of small firms that received 7(a) loans. As reported in a database developed by two private business research and information providers, The Dun & Bradstreet Corporation and Fair Isaac Corporation (D&B/FIC), the credit scores we compared are typically used to predict the likelihood that a borrower, in this case a small business, will repay a loan.[21] In our comparison of firms that received 7(a) loans and those that received conventional credit, we found that for any particular credit score band (e.g., 160 to <170) the differences were no greater than 5 percentage points. The average difference for these credit score bands was 1.7 percentage points (fig. 4). More credit scores for 7(a) borrowers were concentrated in the lowest (i.e., more risky) bands compared with general borrowers, but most firms in both the 7(a) and the D&B/FIC portfolios had credit scores in the same range (from 170 to <200). Finally, the percentage of firms that had credit scores in excess of 210 was less than 1 percent for both groups.

[21]The portfolio management score used by SBA is the Small Business Predictive Score (SBPS). The SBPS is based on consumer and business data and assigns scores to small businesses in the absolute range of 1 to 300, but the practical range of 50 to 250. A lower score generally indicates a greater likelihood of repayment risk, while a higher score indicates a greater likelihood that the loan will be repaid.

Figure 4: Percentage of Small Business Credit Scores (2003-2006) for Firms That Received 7(a) and Conventional Credit in D&B/FIC Sample (1996-2000), by Credit Score Range



Source: GAO analysis of initial credit scores for loans in the SBA portfolio (2003-2006) and D&B/FIC's analysis of credit scores from data on small businesses in the small business portfolio score (SBPS) development sample (1996-2000)

The results our analysis of credit scores should be interpreted with some caution. First, the time periods for the two sets of credit scores are different. Initial credit scores for businesses receiving 7(a) loans in our analysis are from 2003 to 2006.[22] The scores developed by D&B/FIC for small businesses receiving conventional credit are based on data from 1996 through 2000 that include information on outstanding loans that may have originated during or many years before that period.[23] Second,

[22]SBA says it first received SBPS credit scores for the outstanding 7(a) loans in its portfolio in March 2003. Since then, SBA has received an initial score, known as the Surrogate Origination Score, for a 7(a) loan 1 to 4 months after the loan is disbursed. SBA subsequently has received SBPS scores on a quarterly basis for almost all of the active loans in its portfolio. We obtained data for all 7(a) loans approved and disbursed from 2001 through 2005, so the dates of the initial credit scores ranged from 2003 to 2006.

[23]The earlier period of credit scores for firms that obtained credit in the conventional lending market represents data D&B/FIC had readily available and could provide to us.

D&B/FIC's scores for small businesses receiving conventional loans may not be representative of the population of small businesses. Although D&B/FIC combined hundreds of thousands of financial records from many lenders and various loan products with consumer credit data for their credit score development sample, they explained that the sample was not statistically representative of all small businesses.

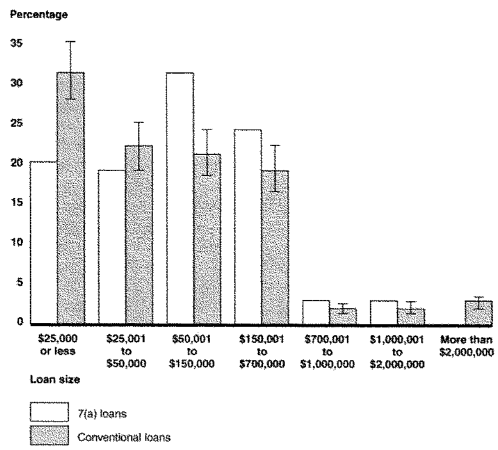
Another score developed by D&B, called the Financial Stress Score (FSS), gauges the likelihood that a firm will experience financial stress—for example, that it will go out of business.[24] SBA officials said that based on analyses of these scores, the difference in the repayment risk of lending associated with 7(a) loans was higher than the risk posed by small firms able to access credit in the conventional lending market. According to an analysis D&B performed based on these scores, 32 percent of 7(a) firms showed a moderate to high risk of ceasing operations with unpaid obligations in 2006, while only 17 percent of general small businesses had a similar risk profile.

As already mentioned, SBA disagreed with the results of our credit score comparison. In its written comments to our prior report, SBA primarily reiterated the cautions included in our report and stated that the riskiness of a portfolio was determined by the distribution in the riskier credit score categories. SBA said that it had not worked out the numbers but had concluded that the impact on loan defaults of the higher share of 7(a) loans in these categories would not be insignificant. Although SBA disagreed with our results, we believe that our analysis of credit scores provides a reasonable basis for comparison. Specifically, the data we used were derived from a very large sample of financial transactions and consumer credit data and reflected the broadest and most recent information readily available to us on small business credit scores in the conventional lending market. As SBA noted in its comments, we disclosed the data limitations and necessary cautions to interpreting the credit score comparison. Taking into consideration the limitations associated with our analysis, future comparisons of comparable credit score data for small business borrowers may provide SBA with a more conclusive picture of the relative riskiness of borrowers with 7(a) and conventional loans, which would also be consistent with the intent of our recommendation that SBA develop more outcome-based performance measures.

[24] The FSS predicts the likelihood that a business will cease operations without paying creditors in full or that will go into receivership.

We also compared some of the characteristics of 7(a) and conventional loans, including the size of the loans. In the smallest loan categories (less than $50,000), a higher percentage of total conventional loans went to small businesses—53 percent, compared with 39 percent of 7(a) loans. Conversely, a greater percentage of 7(a) loans than conventional loans were for large dollar amounts. For example, 61 percent of the number of 7(a) loans had dollar amounts in the range of more than $50,000 to $2 million (the maximum 7(a) loan amount), compared with an estimated 44 percent of conventional loans (fig. 5).

Figure 5: Percentage of 7(a) Loans and Conventional Loans by Loan Size, 2001-2004

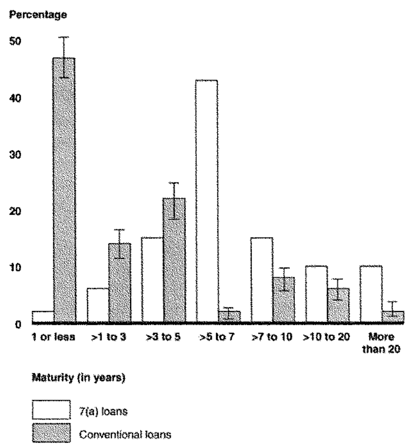


Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95-percent confidence interval. The maximum gross 7(a) loan amount is $2 million. The dollar range categories on this chart reflect program thresholds for loan amounts associated with different interest rates or guarantee fee levels.

Further, almost all 7(a) loans had variable interest rates and maturities that tended to exceed those for conventional loans. Nearly 90 percent of 7(a) loans had variable rates compared with an estimated 43 percent of conventional loans, and almost 80 percent of 7(a) loans had maturities of more than 5 years, compared with an estimated 17 percent of conventional loans (fig. 6).

Figure 6: Percentage of 7(a) and Conventional Loans by Loan Maturity Category, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95-percent confidence interval.

For loans under $1 million, interest rates were generally higher for 7(a) loans than for conventional loans. From 2001 through 2004, quarterly interest rates for the 7(a) program were, on average, an estimated 1.8 percentage points higher than interest rates for conventional loans (fig. 7).[25] Interest rates for small business loans offered in the conventional market tracked the prime rate closely and were, on average, an estimated

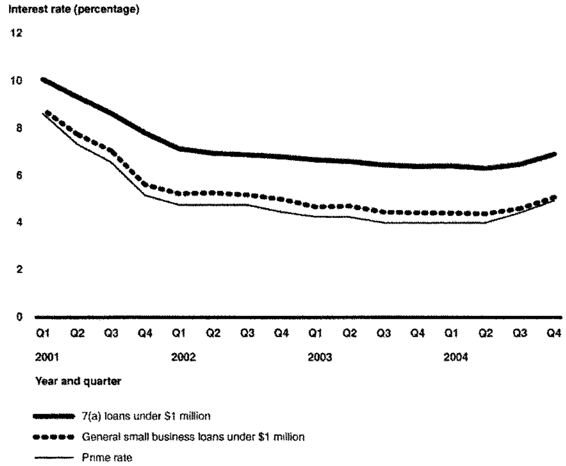
[25]We used SBA data to calculate the calendar year and quarter in which each loan was approved and to calculate interest rates for all loans in a given quarter that were for under $1 million.

0.4 percentage points higher.[26] Because the maximum interest rate allowed by the 7(a) program was the prime rate plus 2.25 percent or more, over the period the quarterly interest rate for 7(a) loans, on average, exceeded the prime rate.[27]

[26]We used the Federal Reserve's *Survey of Terms of Business Lending*, which provides information quarterly on commercial and industrial loans of loans in four size categories (less than $100,000; from $100,000 through $999,999; from $1 million through $999,999,000; and $10 million or more) made only by commercial banks. We used only data related to the first two categories because those loan amounts most resembled the 7(a) loans in the SBA data and, as discussed previously, SBA considers loans reported in call report data of $1 million or less to be for small businesses.

[27]We used the Federal Reserve's historical reports on the monthly bank prime rate to estimate the prime rate for every quarter from 2001 through 2004.

Figure 7: Interest Rate Comparison for Loans under $1 Million and Prime Rate, 2001-2004



Source: GAO's analysis of SBA data, the Federal Reserve Board of Governors' quarterly *Survey of Terms of Bank Lending* (2001 to 2004), and the Federal Reserve Board of Governors' H 15 statistical release for bank prime loan rates.

Current Reestimates Show Lower-Than-Expected Subsidy Costs, but Final Costs May be Higher or Lower for Several Reasons

The current reestimated credit subsidy costs of 7(a) loans made during fiscal years 1992 through 2004 generally are lower than the original estimates, which are made at least a year before any loans are made for a given fiscal year. Loan guarantees can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of the loan guarantees to the federal government and revise its estimates (reestimate) those costs annually as new information becomes available. The credit subsidy cost is often expressed as a percentage of loan amounts—that is, a credit subsidy rate of 1 percent indicates a subsidy cost of $1 for each $100 of loans. As we have seen, the original credit subsidy cost that SBA estimated for fiscal years 2005 and 2006 was zero, making the 7(a) program a "zero credit subsidy" program—that is, the program no longer required annual appropriations of budget authority. For loans made in fiscal years 2005 and 2006, SBA adjusted the ongoing servicing fee that it charges participating lenders so that the initial subsidy estimate would be zero based on expected loan performance at that time. Although the federal budget recognizes costs as loans are made and adjusts them throughout the lives of the loans, the ultimate cost to taxpayers is certain only when none of the loans in a cohort remain outstanding and the agency makes a final, closing reestimate. In addition to the subsidy costs, SBA incurs administrative expenses for operating the loan guarantee program, though these costs are appropriated separately from those for the credit subsidy. In its fiscal year 2007 budget request, SBA requested nearly $80 million to cover administrative costs associated with the 7(a) program.

Any forecasts of the expected costs of a loan guarantee program such as 7(a) are subject to change, since the forecasts are unlikely to include all the changes in the factors that can influence the estimates. In part, the estimates are based on predictions about borrowers' behavior—how many borrowers will pay early or late or default on their loans and at what point in time. According to SBA officials, loan defaults are the factor that exerts the most influence on the 7(a) credit subsidy cost estimates and are themselves influenced by various economic factors, such as the prevailing interest rates. Since the 7(a) program primarily provides variable rate loans, changes in the prevailing interest rates would result in higher or lower loan payments, affecting borrowers' ability to pay and subsequently influencing default and prepayment rates. For example, if the prevailing interest rates fall, more firms could prepay their loans to take advantage of lower interest rates, resulting in fewer fees for SBA. Loan defaults could also be affected by changes in the national or a regional economy. Generally, as economic conditions worsen—for example, as unemployment rises—loan defaults increase. To the extent that SBA cannot anticipate these changes in the initial estimates, it would include them in the reestimates.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other members of the Subcommittee may have.

Contacts and Staff Acknowledgments

For additional information about this testimony, please contact William B. Shear at (202) 512-8678 or Shearw@gao.gov. Contact points for our Offices of Congressional Affairs and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony included Benjamin Bolitzer, Emily Chalmers, Tania Calhoun, Daniel Garcia-Diaz, Lisa Mirel, and Mijo Vodopic.

**Statement of Grady Hedgespeth Director of Financial Assistance
U.S. Small Business Administration
Senate Homeland Security and Government Affairs
Subcommittee on Federal Financial Management**

Chairman Carper, Ranking Member Coburn, thank you for inviting me to testify about the Small Business Administration's flagship loan guarantee program, the 7(a) Program. I appreciate the opportunity to respond to the Government Accountability Office's July 2007 report (GAO 07-769) on the effectiveness of the program in meeting the financing needs of small busineses.

The 7(a) loan guarantee program was established by Congress in 1953 to provide small businesses with the necessary capital that they cannot obtain in the commercial lending market. To be eligible for an SBA guarantee, the borrower must be a for-profit small business, located in the United States and are unable to obtain credit elsewhere. It is important to note that the SBA does not directly make loans. Rather, the SBA works with commercial banks, guaranteeing between 50 percent and 85 percent of loans.

In Fiscal Year 2007, SBA guaranteed approximately 99,600 loans with a combined value of $14.29 billion. In 2006, 97,290 loans were guaranteed with a combined value of $14.52 billion. These 7(a) lending levels demonstrate the importance of this program for a vibrant small business economy.

Analysis by the GAO finds that, when compared to non-7(a) loans, the SBA's 7(a) loans serve a greater percentage of women and minority-owned firms. Historically, these categories of entrepreneurs have faced more difficulty gaining access to capital. While the 7(a) program is not designed to provide a preference for historically underserved borrowers, the fact that they are receiving SBA assistance at greater proportions again demonstrates the program's importance in reaching underserved businesses.

While the SBA is pleased with the 7(a) program's success, we continue to seek out innovative ways to better serve the small business community. For example, to meet the needs of borrowers outside of urban areas, we have recently unveiled the Rural Lending Advantage Initiative. Small businesses account for two-thirds of all rural jobs and comprise more than 90 percent of all rural establishments. However, fewer rural lending institutions have been using SBA programs, and in the last two years, there are almost 400 fewer lenders nationwide that took advantage of SBA loan programs. The Rural Lending Advantage Initiative will streamline the paperwork requirements and offer services online for community lenders who, because they do not regularly deal with the SBA, do not maintain expertise in SBA loan program requirements. This program is beginning in the states of North Dakota, South Dakota, Montana, Utah, Colorado and Wyoming and SBA hopes to expand the program.

Given the 7(a) program's success, it is also important to keep in mind what the program does not do. The 7(a) program is NOT intended to compete with the conventional lending market. Rather, the program supplements this market by providing incentives for lenders to provide loans to firms that may not otherwise qualify for traditional lending products. For banks to obtain an SBA guarantee, they must apply the credit elsewhere standard and certify they would not make the loan without the SBA guaranty. Small business owners must be unable to provide the resources themselves and the lender must be unwilling to make the loan conventionally with similar terms and conditions. According to the GAO report, there are a variety of reasons why small firms have trouble obtaining commercial loans, and thus meet the standard. These factors include: lack of information about the borrower, lack of a previous relationship between the borrower and lender, and lack of collateral. All of the studies examined by GAO on whether credit-worthy firms were being denied loans found evidence of this problem.

The SBA continues to work to ensure that the 7(a) program carefully administers taxpayer resources. In Fiscal Year 2005, the SBA restructured the 7(a) program into a zero-subsidy program. This approach adds stability and independence to the program while ensuring that the lending process is not hampered by appropriations shortfalls such as those that occurred in 2003 and 2004. Aside from having a zero-subsidy rate, another safeguard for taxpayers is that the 7(a) program is not liable for the guarantee if the lender does not comply with the program requirements. In addition, SBA continues to streamline and automate its loan processing functions, to reduce administrative costs.

In order to measure our progress, SBA consistently collects and reviews data on the 7(a) loan program. This includes the:

- number of new loans approved to start-up small businesses;
- number of new loans funded to start-up small businesses;
- number of start-up small businesses assisted;
- number of new loans approved to existing small businesses;
- number of new loans funded to existing small businesses;
- number of existing small businesses assisted;
- number of new loans approved to small businesses facing special competitive opportunity gaps;
- number of new loans funded to small businesses facing special competitive opportunity gaps; and
- the number of small businesses facing special competitive opportunity gaps assisted.

While these measures provide useful data, we are also looking for new ways to better measure our work and identify areas for improvement. Therefore, SBA appreciates the GAO's recommendation that SBA establish additional performance measures specifically to evaluate the effectiveness of the firms in the 7(a) program.

In response, SBA is reviewing its performance measures to determine how best to measure outcomes in terms of the 7a loan program. Data is needed to be able to identify and measure the sustainability of small businesses receiving SBA loans and how the Agency's loan programs benefit the small business economy. The Agency is evaluating whether the data currently being collected provides adequate information to make these determinations. This review will assess past performance and test methodologies that can assist in setting future benchmarks. Specifically, SBA is trying to determine how best to measure the effect of SBA assistance on the firms that receive it. Understanding the Agency's impact on small businesses receiving SBA loans will allow SBA to further tailor its loan guarantee programs to ensure the greatest value for the taxpayer while continuing to fill a key gap in the financial market that allows small businesses to grow.

I would like to again thank Chairman Carper and Ranking Member Coburn for the opportunity to testify and I will be happy to answer any questions.

Testimony Submitted
To
United States Senate
Committee on Homeland Security and Governmental Affairs

Measuring the Performance of the Small Business Administration 7(a) Loans Program?

November 1st, 2007

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The Mercatus Center at George Mason University

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Section 1: Introduction

The promotion of small business is a cornerstone of U.S. economic policy. Policymakers constantly point to small businesses as important sources of employment and economic growth.[1] There are about 25 million small firms in the U.S., employing almost 50 percent of all workers. Hence, even when politicians find little else to agree on, there is strong bipartisan support for government intervention aimed at promoting small business in the U.S.

A particular area of concern for policymakers is whether, in a free market, small businesses can access sufficient credit. The imperfections of credit markets, particularly for small businesses, are often used as the quintessential illustration of a market failure that necessitates government intervention.

Growing firms need resources, but many small firms may have a hard time obtaining loans because they are young and have little credit history. Lenders may also be reluctant to lend to small firms with innovative products because it might be difficult to collect enough reliable information to correctly estimate the risk of such products. If it's true that the lending process leaves worthy projects unfunded, some suggest that it would be good to fix this "market failure" with government programs aimed at improving small businesses' access to credit.

Encouraging lending to small businesses is one of the primary purposes of the Small Business Administration (SBA). Established as a tiny lending agency in 1953, the SBA has mushroomed into a multibillion dollar financial institution with a significant presence in the credit market. By the 1990s, the SBA had become a conglomerate agency pursuing multiple policy objectives. New programs were established to provide venture capital to growth-oriented companies, assist minority entrepreneurs, and lend management assistance to firms struggling to compete.

According to the SBA's Office of Advocacy, nearly 20 million small businesses have received assistance from one of the SBA's many programs since 1953. In particular, the SBA's flagship loan guarantee program, the 7(a) program, has grown significantly over the past decade. In FY2008, the SBA will guarantee $28 billion in loans alone, promising repayment of up to 85 percent if the borrower defaults. With a guaranteed and direct loan portfolio approaching $90 billion, SBA has an critical role as a steward of taxpayers' dollars.

My testimony is devoted to an important issue: the measurement of of the SBA's 7(A) Loan Program's performance. So far, the SBA has done very little to measure the performance of its loan guarantee programs. And to the extent that it has, it has done a very poor job. A recent GAO report finds that the SBA only measures outputs and not outcomes.[2] In other words, the agency has focused its attention mainly on measuring how much it spends on the program rather than measuring the value added to the economy through the program and whether the value added from the program is worth the cost to taxpayers or the underlying financial risk associated with the loan programs. GAO also noted that while the agency is looking into creating outcome based performance measures, there is no timeline for when they will be introduced or how they might work.

Measuring the performance of the loan program is important as it will help the SBA decide whether it should remain in the banking, credit allocation, and subsidy business or whether it should terminate these activities. However, measuring the performance of the SBA loan program is only useful to the extent that it triggers consequences if the program is found to under perform or to be useless.

Section 2: How Does the SBA Work?

The SBA's 7(a) loan program, its largest lending program, is intended to serve small business borrowers who cannot otherwise obtain financing from the private sector.[3] The SBA does not provide loans directly. Instead, after proving that it couldn't get a loan under *suitable* terms and conditions, a small business applies to an SBA-certified bank.[4] The bank then performs a complete analysis of the application. The SBA then reviews the application to decide whether the business should receive a loan.

In order to induce banks to lend money to credit-risky small businesses, the SBA guarantees the loan. If the borrower defaults, the SBA reimburses the lender up to 85% of the loss that the lender would otherwise sustain. With such a guaranty, lenders are often willing to accept a greater credit risk and grant more favorable terms than they might otherwise.[5] To offset the costs of the SBA's loan programs to the taxpayer, the SBA charges lenders a guaranty fee and a servicing fee for each loan approved and disbursed. While these fees are higher than commercial loan fees, SBA loans have easier credit terms and longer repayment periods than most commercial loans.

Section 3: What Should We Measure?

Like every other program, the SBA lending programs are supposed to achieve certain goals. Often, the programs' goals are based on the idea that there is a need somewhere that must be met and/or that the market is not delivering a specific good or service that we, as a society, believe should be delivered.

When thinking about measuring the performances of SBA loan programs, several questions must be asked.

Does SBA have a clear idea of what its goal is?
Do we really have a need for SBA lending programs today?
If a market failure exists, what is its scope and consequences?
Are SBA programs in fact achieving their stated goals?
What is the economic value added of SBA loan programs?
How do you measure that value?
Is the value added worth the cost to taxpayers?

Section 4: Does SBA Have an Outcome Oriented Goal?

The Government Performance and Results Act of 1993 requires agencies to produce strategic plans, annual performance plans, and annual performance reports. Performance reporting started in fiscal 1999. Researchers at the Mercatus Center at George Mason University initiated a Scorecard in fiscal 1999 to foster continuous improvement in the quality of disclosure in agencies' annual performance reports. The scoring process evaluates (1) how transparently an agency discloses its successes and failures; (2) how well an agency documents the tangible public benefits it claims to have produced; and (3) whether an agency demonstrates leadership that uses annual performance information to devise strategies for improvement. An expert team evaluated each report on 12 criteria—four each for transparency, public benefits, and leadership.

One of the many important things the scorecard measures is whether or not an agency understands its purpose or even has a clear understanding of what outcome it is trying to achieve. This year scorecard concludes that in fact the SBA lacks outcome-oriented goals. And if that's the case then they are unable to measure how they achieve that outcome.[6]

SBA's FY06 annual report describes the agency's four strategic goals and 12 strategic (long-term) objectives.[7] The first three strategic goals are programmatic and stated as outcomes, but at such high levels that measurement is challenging. For example, the first strategic goal is: "Improve the economic environment for small businesses." While this is an outcome, it depends on many more factors than just the SBA. Utilizing this as a performance measure is not necessarily indicative of the success or failures of SBA.

Of the seven strategic objectives under the programmatic strategic goals, two are too general to be categorized as outcome-oriented (1.2 "Simplify the interaction between small businesses and the Federal Government through the use of the Internet and information technology" and 2.1 "Increase the positive impact of SBA assistance upon the number and success of small business start-ups"). The fourth strategic goal is management-related and has five strategic objectives ("Ensure that all the SBA programs operate at maximum efficiency and effectiveness by providing them with high quality executive leadership and support services"). While this goal and its objectives are not stated as outcomes, they do cover some areas that focus on enhancing the agency's capacity to accomplish its mission outcomes. The agency does not have a distinct set of annual performance goals, which makes it nearly impossible to track the annual progress towards these larger outcomes.

There is also an issue with the measures being used. The SBA annual report lists 11 agency-wide performance measures and classifies all of them as "outcomes."[8] However, it appears that only about half of these are truly outcome measures. For example, the four measures SBA has used to evaluate the goal of "Increas[ing] small business success by bridging competitive opportunity gaps faces entrepreneurs" all seem to deal with levels of assistance rather than outcomes.[9] Most of the program or component-specific measures covered in the performance section of the report are activity, output, or efficiency measures rather than outcomes. For example, measure 3.1.2 is a useful outcome measure: "Percentage of businesses sustaining physical damage restored within six months after final disbursement of a disaster loan."[10] By contrast, it is difficult to see what impact towards an outcome is demonstrated by a measure for number of research publications issued.[11]

The SBA annual report also lacks inclusiveness by disclosing only a select few measures in its annual report. This hinders the ability to get a clear picture of SBA's success as much as any of the other problems noted. To the extent they are disclosed in the report, the agency's performance metrics are fairly weak overall. The few agency-wide measures described under strategic goals 1 and 3 are good. However, the rest of the measures described in the report lack outcome-orientation. As noted previously, the report does not disclose the rest of the agency's measures and their results. The narratives accompanying the specific descriptions of performance results also are generally weak and provide the reader with little perspective to assist in assessing the agency's performance.

Section 5: Are the SBA's Loan Guarantee Programs Justified Economically?

The SBA's 7(a) loan guarantee program rests on the premise that small businesses are denied adequate credit in the free market because of a market failure. A common assumption is that the main obstacle to new business formation is the inability of would-be entrepreneurs to acquire the capital necessary to start a business. As a result, the assumption underlying the SBA loan guarantee program is that creditors do not lend to small businesses because they are too risky. In a perfect market, creditors would increase their prices to adjust for the higher risk, and in equilibrium, no small businesses would be left without the loans they wanted. The argument is that capital markets are not perfect, however, and as a result, small businesses cannot always get the capital they need to get started or to expand. But when the SBA guarantees a portion of a small business loan, it takes on some of the risk. In this way, the SBA gives lenders an incentive to offer loans to individuals who would otherwise be too great a risk.

In this model, SBA loan guarantees for small businesses are justified as a way to correct financial market inefficiencies that make it difficult for small firms to access capital. But do small businesses really have a hard time accessing capital and getting loans from banks?

Market Failure?

SBA loan guarantee programs stem from the premise that in a free market system some type of market failure denies small businesses credit. The most-cited source of such a failure is the asymmetry of information between lenders and borrowers—potential borrowers know their own financial situation and likelihood of repayment far better than lenders.

In their seminal 1981 paper "Credit Rationing in Markets with Imperfect Information," Joseph Stiglitz and Andrew Weiss explore the effect that asymmetry of information between lenders and borrowers has on the capital market and commercial lenders.[12] According to them, because banks cannot distinguish between high and low-risk borrowers, the demand for credit may exceed the supply. To respond to this situation, banks should increase the price of loans by increasing interest rates. These higher interest rates would then decrease the borrowers' demand for credit. But because of inefficiencies in the capital market, banks do not do this.[13] Instead of increasing interest rates, banks simply ration credit, denying loans to worthy projects.

The SBA and its supporters argue that by guaranteeing a portion of a small business loan, the government takes on some of the risk of the loan. Reducing the risk in this way gives lenders an incentive to offer loans to businesses that they would otherwise deem risky. In this model, SBA justifies loan guarantees for small businesses as a way to correct financial market inefficiencies to reduce the deadweight losses associated with not funding all worthy projects.

The Not-So-Rationed Credit Market

A growing body of research also challenges the belief that credit rationing makes it difficult for small businesses to obtain capital. The academic literature gives no indication that private capital markets do not give credit, at the right price, to the businesses that deserve it at that price. Economists David de Meza and David Webb, for example, have published many articles since the 1980s in various academic journals showing that banks are not reluctant to lend money to small businesses outside the SBA program.[14]

Empirical research confirms this fact. The Federal Reserve Board's 2002 *Report to Congress on the Availability of Credit to Small Businesses* showed that the demand for small business financing closely tracked the pattern of debt growth from 1997 to 2002, which suggests a healthy correlation between the demand and supply of financing.[15]

The Census Bureau's 1992 *Characteristics of Business Owners* survey shows that low sales are a much more important factor in small business failures than a lack of access to financing (see table 1). Of all the unsuccessful businesses in the survey, 71.7 percent of owners cited inadequate cash flow or low sales as a reason for failure; only 8.2 percent said a lack of access to business loans/credit contributed to the end of their businesses.[16]

According to the 2007 GAO report, the studies they reviewed did note some disparities among different groups in their ability to access credit.[17] However, there was no evidence for the reason of the differences and doesn't necessarily implies discrimination.

This is not to say that all potential entrepreneurs have unlimited access to affordable credit. They do not. But it is to say that while some people who want to start small businesses may not have access to affordable credit, a lack of access to affordable credit is not preventing small business formation overall in the United States.[18] Plenty of other small businesses have sufficient access to affordable credit.

This is not surprising. First, banks have a strong incentive to lend money to small businesses: profit. As even the SBA Office of Advocacy admits, "banks that concentrate on a small business niche can realize significant profits and increase their overall market value."[19]

Second, bank loans are only one of many ways to acquire credit. Table 2 shows that while more than 80 percent of small businesses surveyed used some kind of credit, approximately 71 percent used non-commercial bank sources of financing, of which personal credit cards were the most prevalent.[20]

Market Responses to Information Problems

Let's even assume that there is a market failure and that the asymmetry in information between lenders and borrowers leaves many credit worthy small businesses unable to get credit and generate economic growth. This is not scarcity of capital problem it is an information problem. Distributing loans to borrowers on the grounds that they do not have access to credit does nothing to solve the information problem, and it isn't doing to much to identify which of the small businesses rejected by conventional banks could produce real growth either. What's more, the SBA underlying assumption is that only government intervention can address an asymmetry of information, but evidence from the market indicates that such asymmetry is not actually a market failure as financial markets have developed effective private solutions to such information problems.

Lending Relationships

One of the mechanisms that have emerged to address the information problem in capital markets is the development of "lending relationships." In lending relationships, familiarity does not breed contempt; it breeds appreciation. Banks are less likely to ration borrowers that have a history with the bank, larger accounts, and greater expected account growth. When evaluating longtime clients, banks will consider not only the clients' immediate creditworthiness, but also the banks' potential lost profits from damaging good relationships.

Lending relationships are also about gaining information. Repeated interactions with clients for different purposes give lenders information about the clients' creditworthiness—either specific financial information or "soft information" about the clients' characters. This greater information lowers the cost of lending and thus increases the availability of credit.

Credit Scoring

By taking information—such as monthly incomes, outstanding debts, financial assets, length of time at current job, previous loan records, and home ownership—from credit applicants and using statistical methods to generate numeric scores, credit scoring can predict the applicants' propensities to default or become delinquent. Credit scoring not only reduces greatly the cost of information-gathering, but, by improving a bank's ability to predict default, it also helps banks lend funds to borrowers more accurately.

In fact, the evidence suggests that credit scoring has increased the availability of credit to small firms. For instance, research by Allen Berger, Scott Frame, and Nathan Miller (2005) suggests that small business credit scoring is associated with increased small business lending, higher loan prices, and greater average loan risk.[21] They find that credit scoring increases credit availability for relatively risky borrowers. Credit lender will simply have these risky borrowers pay relatively higher interest rates for their loans in order to compensate for the risk they represent. "The result" says Dr. Chad Moutray, Chief Economist for the Office of Advocacy at the SBA, "is a financial market that tends to efficiently allocate capital to small businesses."[22]

Section 6. Is the SBA Doing What It Says It Does?

The economic justification for any government-sponsored lending or loan guarantee program must rest on a well-established failure of the private sector to allocate loans efficiently. Absent such a private sector deficiency, the SBA's activities would simply be a wasteful, politically-motivated subsidy to this sector of the economy. As demonstrated in the previous section, the private sector does not seem to suffer from such deficiencies, which suggests that there is no economic justification for SBA loans.

Yet many argue that some public policy objectives require the sacrifice of marketplace efficiency. It is an accepted feature of modern American government that some public interests or social policy gains can outweigh economic losses and hence are worth selected override of our free-market values. In the case of the SBA, its lending programs could fulfill specific public policy objectives that the marketplace on its own would not otherwise serve or would supply at suboptimal levels. But does it?

In describing its role in the economy, the SBA proclaims that small is beautiful: "Small business is where the innovations take place. Swifter, more flexible and often more daring than big businesses, small firms produce the items that line the shelves of America's museums, shops, and homes. They keep intact the heritage of ingenuity and enterprise and they help keep the 'American Dream' within the reach of millions of Americans. Every step of the way, SBA is there to help them." From this belief, it naturally follows that we need more small businesses around and should implement policies that will increase the number of small businesses. Glorifying small businesses also leads to the idea that small business owners deserve assistance because they are morally admirable and more deserving than big business owners. They create more jobs and economic growth than larger firms while facing what some consider to be unfair competition from big business. Along the same lines, the SBA points to racial and gender disparities as a justification for assistance to disadvantaged groups in particular.

SBA can thus be judged based on its ability to meet these public policy goals—namely, to fill the gap between supply and demand of small business loans, particularly for women- and minority-owned small businesses. To measure the SBA's results, I have analyzed the flow of SBA credits to evaluate who receives them and whether the SBA is meeting its stated policy objectives to promote new startups, to encourage female and minority business owners, and to help small businesses become big ones.

A close examination demonstrates that neither stated SBA policies nor its actual lending patterns provide evidence that SBA loan guarantees serve any focused or rigorously defined public policy purpose at all.

SBA Lending Profile

In the recent AEI working paper, I looked at the flow of SBA credit in order to identify how well the SBA is serving its stated objectives, such as promoting new startups, helping small business compete with big business, and stimulating high tech investment, economic growth, and job creation.

Seven main conclusions could be drawn from the data.[23] One, no more than 1 percent of small businesses loans are SBA loans each year. This makes it hard to argue, as the SBA does, that it is helping solve a credit rationing problem and that without SBA loans small businesses would have a hard time accessing credit. The private sector finances most loans and hence, the SBA is largely irrelevant in the capital market.

Two, 75 percent of SBA 7(a) loans go to helping a very small fraction of small businesses in mainstream service, retail, and wholesale sectors. Even in those sectors most likely to receive SBA loans, only about 1 percent of all firms do.

Three, the SBA is helping a minuscule fraction of small businesses in each sector compete against other small businesses in the same market. In the 25 sectors receiving the largest share of SBA 7(a) loan guarantees, less than 0.5 percent of the small businesses received the guarantees.

Four, there is no shortage of firms or new startups or services in America. Looking at the data, there is no compelling reason to suggest that new businesses would not be started without the SBA's 7(a) loan program since less than 3 percent of start-ups received SBA loans between 1998 and 2002.

Five, in 2004, 29 percent of 7(a) loan guarantees went to minority business owners but SBA distributed loans to only 3 percent of all minority owned firms. This makes it hard to argue that SBA loans programs have a significant impact on minority owned small businesses. The same trend is true for women-owned firms.

Six, markets are functioning well in the sectors that account for 75 percent of SBA lending. There are an overwhelming number of firms, a large amount of competition, and no empirical evidence that the market is being underserved in these areas.

Seven, most of the restaurants, car repair shops, grocery stores, dry-cleaning stores, and daycares that compete with SBA borrowers paid the market rate to meet their credit needs. By giving a credit market advantage to some small businesses, the SBA ends up harming the competing small businesses.

In short, it appears that no unique policy objectives are served by extending subsidized credit to less than 1 percent of the firms that supply basic economic services.

Using FY2005 numbers, the GAO recently confirmed these finding. The GAO report finds that 7(a) program guaranteed 90,000 loans valued at $14 billion in FY 2006. It notes that 7(a) represents about 4% of all outstanding small business loan dollars and 1.3% of the number of outstanding small business loans in 2005.[24]

GAO also notes that from 2001 through 2004, more than a quarter of 7(a) loans went to small businesses with minority ownership and about a quarter to start-ups, compared to about 10 and 5 percent of conventional loans that went to minority-owned business and start-ups. For female-owned small businesses and small businesses located in economically distressed neighborhoods, the proportions of 7(a) and conventional loans were more similar (22 percent versus 16 percent for female-owned and 14 percent versus 10 percent for distressed neighborhoods.

However, even though this data is interesting it doesn't say much about the relevance of SBA loans. The true question is really, of all the loans going to women or minority owned small businesses, how many were SBA loans. Using the GAO data, we find that even though a large share of SBA loans went to women and minority owned businesses, less than 5 percent of all loans going to women and minority owned businesses were SBA loans.

Responding to the Argument that SBA's Relevance Rests on Long Term Lending

In response to the argument that 7(a) loans represent 1.3% of the number of outstanding small business loans in 2005, we often hear that what really matters is that 7(a) loans represent 40 percent of long term loans (defined as loans that last for 3 or more years). In the word of David Bartram—chairman of the National Association of Government Guaranteed Lenders (NAGGL), a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program, and president of the SBA Division of US Bancorp, the nation's sixth-largest financial services company—" [long term borrowers are] the real targets that SBA hits upon. Not every small business out there, but companies that need long term financing."[25]

Everyone understands the value of being able to have access to longer term loans. However, there is a sound reason why banks usually do not extend long term loans to small businesses. It's not that they are mean or want to hurt small businesses. They're simply reducing the risk of lending money to small businesses.

Loans to small firms, firms with low ratings, and firms with little cash available to service debt, for example, are more likely to be small, secured by collateral, and have a short contractual maturity. Larger and more profitable firms are able to borrow on better terms across all three of these non-price dimensions. However, economist Philip Strahan (1999) explains, the price and non-price terms of loans are jointly determined to help solve information problems; pricing, collateral, maturity and loan size are used as complementary tools to deal with borrower risk.[26]

Banks put smaller, less profitable and more opaque borrowers (as measured by the market-to book ratio) on a shorter leash. These borrowers must go back to the bank more often than larger, better established firms to prove that their prospects remain bright. It doesn't mean that they do not ultimately have access to long term lending. It just means that they have to go back to the bank more often to extend their loan. This is the price of having access to capital at suitable terms rather than not having access to capital or having access to it at extremely high rate.

Another set of tools that financial institutions use in debt contracts to solve the informational opacity problems of small businesses include restrictive covenants and choice of maturity. The debt contracts issued by commercial banks, finance companies, and other financial institutions are often covenant-rich, requiring the borrower to return to the institution to renegotiate these covenants when strategic opportunities to enhance value arise or when the financial condition of the firm changes (Berlin and Loeys 1988, Carey et al. 1993). In part, these covenants and their renegotiations are intended to give the lending institution more control and prevent borrowers from engaging in risk-shifting behavior. By using specific financial ratio and activity restrictions linked to periodic submission of financial information, covenants limit the firm's ability to change its financial condition or strategy. Thus, covenants can force a borrower to obtain permission from its lender before embarking on significant strategic changes. One theoretical result is that the strictest covenants are expected to be placed on the firms with the most credit risk and greatest moral hazard incentives (Berlin and Mester 1993). Interestingly the data show that these restrictions benefit small firms because these firms end up using an experienced banker or financial institution that can guide them through difficult business choices.[27]

In the long run, the length of the loan doesn't matter. Small businesses that want/need long term loans, but are risky and have difficulty getting access to capital, are likely to have loans with shorter maturity and then renegotiate those loans. So a firm that is getting a conventional short term loan and a firm that is receiving a SBA long term loan could both be undertaking similar long term projects. If both ways can provide the same result--the firm getting financed--then why does it matter if the loans are successive short term ones or a single long term loan? It doesn't. Moreover, even in this artificially defined market of "long term loans", the private sector provides 60 percent of the loans without the federal guarantee.

Finally, there is an important fairness question attached to this issue. If long term financing is such an important factor in the success of small firms, why should some borrowers benefit from it while others don't? In particular, why should small businesses owners who haven't been able to get credit through traditional means and prove themselves worthy of the trust of a commercial bank benefit from terms to which most creditworthy borrowers don't have access Why should not being able to get credit in the first place payoff in the end?

Section 7. Measuring the Value of SBA Loans

The evidence presented above points in one direction: the SBA's 7(a) loan guarantee program is unlikely to have a significant positive effect on the market. But you would never know this from the SBA's evaluations of its programs. The SBA does not publish or even try to measure the gains, whether economic or social, of its programs. In fact, the SBA's only measure of success amounts to stating how many loans have been guaranteed in a given year and how much it has spent on small businesses, rather than measuring the return on its efforts.

As noted by the GAO in July 2007, the SBA does not collect any information to determine how well firms perform after receiving 7(a) loans. So there is no way of knowing if the program is reaching its strategic goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs."[28]

Remember that the theory behind SBA lending programs is that lenders overlook borrowers that if given access to credit would generate economic growth. As such, measuring the performance of SBA loans should include their effect on economic growth. It is possible, for instance, that even though a large share of SBA borrowers default on their loans, the economic growth triggered by the other borrowers compensates for the losses. In addition, the Office of Management and Budget doesn't publish the details of its actuarial analysis of the proper level for the SBA program fees. In other words we are left in the dark about the performance and economic impact of SBA loans.

Job Creation is Not an Appropriate Outcome Performance Measure

One mistake that is often made by agencies when talking about their achievements is to try to account for the number of jobs created. However, the mere creation of jobs is not an appropriate economic policy objective. You can add jobs to an economy yet create no economic value. For example, imagine hiring someone to dig a hole every morning and someone to fill it in every afternoon: you create two jobs, but nothing of economic value. A striking real-life example is the former Soviet Union, where unemployment was low because the government gave a job to everyone, and yet the economy was stagnant.

Economic policy is appropriately directed towards economic growth whether it takes the form of additional jobs or a productivity increase in existing jobs. There is no reason to base our policies on the idea that new jobs are creating more economic value than existing jobs, or that small business jobs are more valuable than jobs at large firms.

It important to remember that targeted policies—whether they take the form of direct subsidy, tax credit, loan guarantee—have often proven to be bad policy. Here are three reasons.

(1) Special treatment creates special interest groups that tend to undermine the application of economic efficiency criteria. Preferential government policies have inspired small businesses to join together to protect their benefits and lobby for more. Thus joined together, they have lobbied for policies that benefit all small businesses equally, which draws resources to those who do not deserve it. While the powerful small business lobby has won some targeted policies that are consistent with promoting general economic growth, such as cutting marginal tax rates and red tape, these worthwhile policies have been accompanied by many inefficient programs. The great majority of SBA activities are wasteful and unnecessary.

(2) Special treatments are bound to be inefficient. For one thing, they never go away, even if conditions change to make them no longer necessary. Government officials are reluctant to acknowledge policy failure and the targeted group has a strong incentive to want the policies to be made permanent.

(3) The practical implementation of special treatment for small businesses has perverse side effects. If regulations and tax laws favor small firms over large ones, it will make it more profitable to stay small rather than grow. This perverse incentive will lead to a misallocation of resources away from their most productive uses and will interfere with the natural growth and evolution of firms.

For the typical small business benefit, firms will lose the targeted benefit when their employment, assets, or receipts surpass a certain limit specified by law. This hidden cost has been described as the "notch problem," and it is an unavoidable byproduct of the design of many programs targeted at small firms. Such a design creates a disincentive to grow beyond that limit.

For instance, if a firm doesn't hire more than 49 employees, it avoids mandatory family and medical leave; or if an employer does not hire more than 10 employees, he is exempt from most OSHA requirements for recording and reporting occupational injuries and illnesses.

What is the Value of the SBA's Loan Programs?

In his 1985 Congressional testimony, former director of the Office of Management and Budget David Stockman wrote of the 7(a) loan program, "SBA conducts a $3-4 billion annual lending program which indiscriminately sprays a faint mist of subsidized credit into the weakest and most prosaic nooks and crannies of the nation's $4 trillion economy. In the process it serves no rigorously defined public policy purpose objective."

Twenty years later, it seems that very little has changed. Now, the SBA runs a $28 billion loan program and we have a $12.8 trillion economy. However, SBA credit volumes are still inconsequential in the market as a whole since they reach such a tiny fraction of small firms. Most SBA loans still go to helping small businesses in service, retail, and wholesale sectors, but even in these industry sectors most likely to receive 7(a) loans, no more than 1 percent of small businesses receive the loans in any given year. Similarly, the evidence suggests that the SBA's loan guarantees are not targeted to helping small businesses compete with big businesses.

But why does this matter? The SBA may not be having a large effect in a macro sense, but it does have some impact in a micro sense. The U.S. economy may not be better off because of SBA loan guarantees, but the individual recipients are certainly helped. In fact, advocates of the SBA's lending programs remind us that few of the beneficiaries will become tremendous success stories like FedEx; most will stay small. The problems with this scenario are twofold: one, anecdotes about the program's success are not enough to make the case that it creates value because the costs to taxpayers may far exceed the benefits; and two, the program creates an unlevel playing field that in some cases ends up hurting other small businesses.

The Cost to Taxpayers

Congress determines the total amount of loans the SBA is able to guarantee. In its FY 2007 budget request, SBA asked to be allowed to guarantee $28 billion in loans, of which $17.5 billion would be for 7(a) loans.[29] However, there was no money appropriated for it.

Traditionally, to effectively manage a loan program, fees are charged to the borrowers for the loans. In the case of SBA loans, the fees are charged to both the borrower and the lender for each 7(a) loan. Additionally, in order to compensate for anticipated defaults on 7(a) loans, funds are set aside to cover expected losses: a "subsidy rate" is used to calculate how much needs to be set aside. The Office of Management and Budget (OMB) has been responsible for setting the final subsidy rate calculation.

In 2005, Congress agreed with the Bush administration's plan to eliminate the subsidy for the 7(a) loan program. Instead of paying off loan defaults with taxpayer dollars, users of the 7(a) loans would be required to pay sufficient fees to cover the costs.[30] The cost of running the program and oversight are still paid for with taxpayers' dollars.

The difficulty is this: Over the years, there has been much dissension on how to effectively calculate the subsidy rate—whether this rate be zero or not. Until recently, studies of the loan program showed a profound inability to establish a subsidy rate that would cover projected loan defaults or to establish the proper level of fees to make the rate zero. For instance, in 2001, the Government Accountability Office (GAO) released a report showing that the SBA's approach of averaging historical data was causing large overestimates in subsidies.[31] However, the report mentioned that SBA was currently working on an econometric model to address the problem.

In FY2003, SBA began using the new econometric model, and it seems to be working well so far. In 2004, the GAO analyzed the new model and concluded that the model was reasonable.[32] The GAO did suggest that SBA: 1) update the model over time, 2) decide whether it might be appropriate to include additional variables in the model, and 3) release how exactly they constructed the model so that the model could be examined in more detail by outside sources. According to the SBA's 2005 annual report, the most recent reestimates of expected 7(a) losses were the "smallest in the program's history." They attributed this improved accuracy to the stability of the ongoing loan performance as well as the consistency of the credit subsidy model.[33] The SBA may not be the most objective judge of its own program, but it does seem that progress has been made in the last 3 years.

Whether the accuracy of the model can continue, however, is still an open—and crucially important—question. Neither the OMB nor the SBA publishes estimates of the size of the subsidy or its economic impact, but according to an estimate from the Congressional Budget Office, in FY2003 the subsidy was on track to be more than $1 billion over ten years.[34] Since then, the SBA has raised its loan fees, which should have achieved breakeven levels, yet the SBA has required taxpayers to pay for unexpected losses, suggesting that fees are still too low and there remains a subsidy.

What's more, if the economy suddenly takes a turn for the worse, for instance, and small businesses become much more likely to default on their loans, does the SBA's model account for such events? If not will the agency be prepared to cover the increased costs? Or will taxpayers have to bail out the SBA? In addition, the SBA's Office of Inspector General has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud.[35] As long as the SBA guarantees such a high percentage of the loan amount, banks have very little incentive to thoroughly evaluate loan applicants. Can the model accurately predict the costs of loans made by minimally-supervised lenders?

The threat of high default costs is very real. The default rate for the SBA's loan programs is higher than in the private sector. Glennon and Nigro (2005), for instance, look at a sample of seven-year maturity SBA 7(a) loans disbursed from 1983 to 1998.[36] They analyze the riskiness of SBA loans by measuring the cumulative default probabilities. Using the same methods that Moody's and Standard & Poor's use to evaluate corporate bonds, they find that SBA loans rate between Moody's B and Ba ratings and between Standard & Poor's BB and B ratings. This is the upper end of speculative grade; i.e., "SBA loans are concentrated in the relatively more risky segment of the loan market." However, they note that earlier research shows that, at the end of 1997, nearly half of the rated assets of commercial banks were comparably risky.

They then measure the default rate. Approximately two-thirds of the loans in their sample went to existing firms and one-third to start-ups, with a vast majority to firms with 25 employees or less. They find that default rates vary by industry sector and by firm size. Across all the different categories, the default rate is generally around 15 percent. This number is higher than the GAO's 2003 estimate that the default rate on 7(a) preferred lender loans has averaged about 14 percent in recent years.[37]

Glennon and Nigro then refine their data and measure the default by cohort. They look at loans by year of disbursement, which controls for "the impact of changes in program guidelines, the aging (or seasoning) of the loans, and the censoring of observations in 1998 [i.e., the data stops in 1998, and not all of the loans have reached maturity by that time]".

They find that the average annual default rate, which adjusts for the shorter exposure time of the censored loans, declines after 1987, reaching a low of 2.6 percent, and then rises after 1993, reaching a high of 4.6 percent in 1995. The cumulative default rate for the non-censored cohorts falls over time, from almost 30 percent in 1983 to less than 20 percent in 1991. The censored cohorts show that the risk of default is time-dependent: the rate of default increases over the first few years after disbursements, then declines as the loan matures further.

According to the SBA's own data, for its 2005 cohort of 7(a) loan guarantees, the cumulative default rate was 7.4 percent, and it is 7.21 for the 2006 cohort so far. This is outstandingly high compared to the private sector. For all business loans ("commercial and industrial" or "C&I" loans) from all FDIC-insured banks, the annual net charge-off rate—i.e. loans that the lender no longer expects to be repaid—is very low, typically less than 1.5 percent.[38] But this includes both small and large businesses. Default rates for small businesses alone are expected to be significantly higher because of their riskier nature.

The FDIC does not collect data on default rates for small businesses specifically, so it is difficult to compare SBA-guaranteed loans to small business loans in general. A rough comparison is the charge-off rate for credit cards, since credit cards tend to be used for higher-risk borrowing. If small business owners get turned down for traditional bank loans, they might turn to non-traditional credit sources, like credit card borrowing. Charge-off rates for credit card lenders are a lot higher, but still lower than SBA loan default rates. For instance, in 2005, the annual net charge-off rate for credit card lenders was 4.64 percent, while the default rate for SBA-guaranteed loans disbursed in 2005 was 7.4 percent.[39]

Of course, this disparity is understandable. To qualify for an SBA loan, one must first be rejected at least once by a private funding source. However, it doesn't mean that it makes economic sense. Edwards (2004) explains that "If a small business has a sound business plan with solid prospects, it should be able to raise debt and equity capital in private markets. If a small business has shaky finances and poor prospects, it will be denied private capital, which is a good thing because such loans would be economically wasteful."[40] Yet these "shaky" small businesses are exactly whom the SBA lends to: the SBA's mission is to lend money to those rejected by the private banking sector because they were perceived as too risky and unlikely to make money.

The implicit assumption is that bringing a small business to life that would not have existed without the SBA is worth the cost. But if that's the case, the SBA needs to demonstrate that claim. We know that the agency doesn't give a loan to every small business owner who applies for a loan. It rejects many applicants. Yet the SBA does not provide a model explaining how it, unlike the private sector, is capable of identifying the winners among the losers—those previously rejected. If the SBA really could pick winners, its value would be clearer. Its lending programs could be justified by its ability to identify those who would become the next Amazon.com among the small businesses rejected by commercial banks, thus allowing economic value to be created where it would not have been otherwise. Of course, even if the SBA had a way to identify future winners in a way that the private sector cannot, it would still have to make the case that these winners are worth the cost to the taxpayers.

Unfortunately, that's hardly the case. A recent report by the Office of Inspector General (IG) for the SBA details several programs and activities by the SBA that are particularly vulnerable to fraud, waste, and other inefficiencies.[41] Posed as a series of "challenges," the report includes an assessment of the SBA's progress in improving the areas of concern. Among other concerns, the report examines the 7(a) loans and notes that the program, as well as SBA loan programs generally, requires better oversight and monitoring to improve control and reduce fraud risk. In addition, the report mentions the SBA's difficulty in identifying viable businesses.

Almost every local SBA office has its own web page with numerous "success stories." Even though some of these stories are impressive examples of entrepreneurship, most are about businesses basically managing to stay afloat, rather than maturing into fast growing businesses. Also, these are nothing more than anecdotes, which is hardly a basis for sound cost-benefit analysis.

What's more, the two main SBA success stories seem to be Outback Steakhouse and Staples.[42] In 1990, Outback Steakhouse received $151,000 in working capital, with which, according to the SBA, the restaurant obtained the size it needed to go public. Of course, the rest is history, and now Outback receives about $3.6 billion in sales. Staples received about $1.5 million in 1987 so that it could expand from just a single store to five stores. It went public in 1989 and now has about $16 billion in sales.

Those two examples regularly trumpeted by the SBA hardly make the case for the legitimacy and productivity of SBA loans. First, SBA's success stories are at least 16 years old. Does it mean that since 1990 no SBA loan has resulted in such a successful business story? But even if SBA loans resulted in one such success story every year, it is not obvious, without proper empirical evidence, that it would justify the cost to taxpayers of defaulted SBA loans. And again, it is surprising that the SBA is not concerned about measuring the return on the taxpayers' dollars that it spends.

Second, those two success stories were not funded with the SBA's flagship 7(a) loan program but with its Small Business Investment Company (SBIC) program. Established in 1958, the program was meant to be a unique tool that provides risk capital in the form of debt and equity financing to small businesses for their growth, modernization, or expansion. There are currently over 400 SBICs nationwide, with a capital base of more than $23 billion. SBICs are privately owned and privately managed investment firms, licensed and regulated by the SBA, that use their own capital, plus funds borrowed with SBA guarantees, to make venture capital investments in small businesses.

However, this program has frequently been criticized for being inefficient and wasteful. The IG report cited above also examines concerns pertaining to the SBIC and charges that with $12.5 billion in the form of guaranteed debt and equity interest, the program places too much risk on taxpayer funds. In other words, the return on taxpayers' dollars is negative. While the report does document progress made in addressing these challenges, it concludes that much remains to be done.

In response to an editorial in the Wall Street Journal listing major flaws with the SBIC programs, the Ranking Member on the Small Business Committee, Representative Nydia Velazquez (D-NY), wrote that "four years later, under the Bush administration, there has been $1.1 billion in losses."[43] In other words, SBA's two business stories were founded by a program that clearly has negative return to taxpayers' dollars and should be shut down.

SBA Loan Guarantees Hurt Other Small Businesses

Since this small distribution in highly competitive sectors is unlikely to greatly improve the prices and products available to consumers or significantly bolster economic growth, the primary effect of the loan guarantees is to create an unlevel playing field. Small business owners must be denied traditional credit before they are eligible for 7(a) loans. Because they, by definition, do not qualify for loans at market rates, the 7(a) loan program allows them one, to receive money that they might have never received and two, to receive funds a lower rate than they otherwise would have. All other small businesses, however, pay the market rate that reflects the actual risk they represent.

For the most part, the SBA helps a very small fraction of small businesses that are not creditworthy compete with unsubsidized firms in naturally competitive healthy markets. Hence, the SBA is hurting a large portion of small businesses in the name of helping very few others.

Section 8: Banking on the SBA

The SBA's loan guarantee programs benefit a few at the expense of the many. One major beneficiary is SBA lenders. The SBA does not provide loans directly; rather, borrowers have to apply to an SBA-certified bank.

How Do Banks Benefit?

Banks benefit from the SBA program in several ways. First, when a small business defaults on its obligation to repay an SBA loan, the bank does not bear most of the cost.[44] Thus, even though SBA borrowers are riskier than others, the downside risk to the bank is at most 25 percent of what it would be were the loan not guaranteed by the government. In some cases, the loan guarantee even makes the risk for banks lower for SBA loans than for traditional loans.

Second, under normal circumstances, banks would not issue loans to the small businesses in the 7(a) program, because the high risk of default on the loans means that banks would not profit on the loans.[45] But with the government guarantee of these loans, banks now can make a profit of SBA loans. According to David Bartram—chairman of the National Association of Government Guaranteed Lenders (NAGGL), a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program, and president of the SBA Division of US Bancorp, the nation's sixth-largest financial services company—"we can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly." [46]

Third, through the SBA's Secondary Market Program, lenders have another way to reduce their risk even further and also to increase their lending capability.[47] Lenders pool the guaranteed portions of SBA loans and then sell to investors trust certificates that represent claims to the cash flows. In other words, the guaranteed portions of the loans are turned into tradable securities or "securitized."

Generally, securitization involves grouping assets—such as residential mortgages or car loans—into large pools that are sold as securities to investors. The originator of the security will often offer loss protection to enhance the credit rating of the security. Lenders benefit from the increased liquidity and asset diversity; borrowers may benefit from lower financing costs; and investors benefit from greater liquidity and lower risk than if they had invested in the loans directly.[48]

To encourage a secondary market, Congress passed a law in 1984—the Small Business Secondary Market Improvement Act—that reduced regulatory barriers for the securitization of small business loans.[49] Under this law, SBA provides a secondary guarantee of the trust certificates—guaranteeing timely payments on the certificates if the borrowers' payments are late. According to the Congressional Budget Office, through the Secondary Market Guarantee

Program, SBA is taking on risk in addition to the initial guarantee of payment of the principal and interest in the event that borrowers default and the agency purchases the loans.[50] That additional guarantee makes the securities more valuable to investors, who are, as a result, willing to pay more for them.

The data confirms that point. Small business loans are typically not good candidates for securitization. Because the loans' terms vary so much, their underwriting tends not to be standardized, and their risk requires such a high degree of credit enhancement, securitization becomes unprofitable. But SBA-guaranteed loans do not have these problems, and most of the small business loans that have been securitized are SBA 7(a) guaranteed loans. From 1994 to 2001, over 40 percent of the guaranteed part of all 7(a) loans was securitized. By contrast, slightly less than 10 percent of the unguaranteed portion of 7(a) loans was securitized. The advantage of the SBA guaranteed loans is clear: between 1994 and 2001, almost $22 billion of SBA guaranteed loans was securitized, while only about $4 billion of conventional small business loans was securitized.[51]

And this is done at low cost to lenders since under current law, the SBA charges no fee for the 100 percent secondary market guarantee. Only if the loan is sold for more than 110 percent of the outstanding principal balance is half of the excess paid to SBA.[52]

How Profitable Are 7(a) Loans to Banks and Lending Institutions?

The NAGGL website, a member-only site, states that "return on assets of SBA loans can easily exceed 5 percent, and return on equity can exceed 70 percent."[53] While return on assets is a poor measure of profitability, return on equity is not. Return on equity (RoE) reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. A 70 percent RoE is remarkably high. As of January 8, 2007, the RoEs for the two biggest banks in America—Citigroup and Bank of America—were 18.36 percent and 16.56 percent respectively.[54] Even the credit card company American Express, which enjoys a higher return because it requires fewer assets than commercial bank to conduct its business, doesn't show such incredible return on equity. In January 2007, its RoE was 34.2 percent.[55]

In a Congressional hearing, NAGGL's chairman explained that "if you were to sell the SBA guarantee portion, now you have only 25 percent of direct exposure on your bank's books [...] so that is the reason why there is a leveraging power there. That is the reason why the loan can be profitable." He also concluded that because of the federal guarantee, SBA loan business is a higher-end business to lenders.[56]

Who are the recipients of these sky-high returns? Reviewing a representative sample of 2,267 7(a) loan lenders, the FY2006 data shows that the sample 7(a) lenders issued 97,290 loans,[57] for a total of $14.5 billion of which SBA guaranteed $10.2 billion or approximately 70 percent. The top ten banks in the United States issued 51 percent of the 7(a) loans. Expand the list to the top twenty banks in the United States and the percentage rises to 65 percent.[58] Bank of America leads the list of institutions. Others on the list are J.P. Morgan Chase, Wells Fargo & Co., and Capital Financial. The biggest banks in America are the ones benefiting the most from the SBA loans programs.

If SBA Loans Are So Profitable, Why Doesn't Entry Dissipate the Rents?

Economic theory tells us that if excess profits exist in a given market, new firms enter until profits are normal. If SBA loans produce high returns, more lenders should enter the resulting competition should eliminate the exceptional returns. But if the return on equity remains high and there are no legal barriers to entry, profits must not be high enough to make entry cost effective for new banks.

There are about 6,000 banks and BHCs' serving millions of small businesses in the US.[59] According to the office of lender's oversight, in 2006 there were 4959 SBA lenders. It means that it is not hard to become an SBA lender. However, according to the National Small Business Association, only 2,751 of them originated at least one loan in 2006. And the SBA data presented above shows that only 10 of them issued over half of the SBA loans meaning that the other 2,741 issued very few of the loans.

According to SBA lenders, SBA compliance requirements are complex and costly. Often, it is not cost effective for most banks to issue SBA loans even when they are SBA lenders. For instance, large banks have enough resources to train and devote several fulltime employees to SBA loan practices. Smaller banks can't afford it and never develop the required expertise. Also, large banks have automated systems to meet SBA compliance requirements and have better and lower cost credit scoring mechanisms in place. Smaller banks hence never or rarely issue SBA loans. The high cost of issuing SBA loans serves as a barrier to entry to the SBA lending market and shelter big banks from competition which explains the recurring and high profit they make on SBA loans.

Private Profits, Public Losses

Banks benefit, but the taxpayer pays. Because the SBA guarantees such a high percentage of the loan amount, banks have little incentive to evaluate loan applicants thoroughly, and the SBA applies little oversight. The SBA's Office of the Inspector General (OIG) has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud. [60] The OIG recently found that during the first half of FY 2006, 43 percent of SBA purchased guarantees were made inadequately. As a result of this data, the OIG projects that SBA erroneously distributed $36 million in loans, a rate of about 17 percent.[61]

The Government Accountability Office echoes these concerns, pointing out that if the economy were to plunge suddenly, 7(a) loans borrowers would increasingly default on their loans, forcing taxpayers to send large sums of money to SBA banks. As of last year, these guarantees represent some $83 billion in potential taxpayer liabilities, a risk that banks would otherwise assume.[62]

Lawmakers sell the SBA loan program as a program that helps small business, an important and popular institution in the United States. In reality though, the SBA loan program is actually a form of corporate welfare for America's biggest banks. The banks reap profits from this program, but the taxpayers have much to lose.

Section 9: Conclusion

Supporters of the SBA's loan programs argue that the government's assistance aids small businesses by filling a gap in financing when banks and other traditional sources do not provide loans for the purposes, in the amounts, and with the terms required by small business borrowers. However, a large economic literature dismisses this argument and demonstrates no failure of the private sector to allocate loans efficiently, thus discrediting the economic justification for any government-sponsored small business lending or loan guarantee program. Absent such a clearly identified problem, the SBA's activities are simply a wasteful, politically-motivated subsidy to this sector.

Moreover, even if to some extent the private sector fails to allocate loans efficiently, it remains to be proven that government intervention is a more desirable alternative. In fact, the data demonstrates that even if credit were a serious problem for small firms, SBA loans wouldn't be of much help to them. The SBA's 7(a) loan guarantees serve only a tiny fraction of the nation's small businesses, and most of the program's borrowers could obtain financing without the SBA's help.

In the end, the burden of the proof is on the SBA who needs to demonstrate that its loan program generates economic growth. It should measure what the benefits of the program are and also what the costs are.

To conclude, most of the nation's 25 million small businesses are funded and grow without government subsidies. Entrepreneurship is definitely one thing that Americans know how to do without government help. The SBA loan guarantee program doesn't seem to help deserving small businesses and should be terminated.

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[1] For a discussion on whether small businesses are the fountainhead of job creation see Veronique de Rugy (2005), "Are Small Businesses the Engine of Growth," AEI Working Paper, http://www.aei.org/publications/filter.all,pubID.23537/pub_detail.asp

[2] GAO (2007), Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance GAO-07-769 July 13.

[3] The SBA criteria for a 7(a) loan are very broad. An applicant must be a for-profit enterprise without the internal resources necessary to finance its activities. It must be able to demonstrate capacity to repay the loan, and it must be considered a small business by the SBA. As the SBA defines a small business as a firm with less than 500 employees, almost all U.S. firms are "small." (A comprehensive definition of small businesses across industries can be found at www.sba.gov.) According to the SBA's Office of Advocacy, small businesses represent 99.7 percent of all employer firms in the United States. SBA Office of Advocacy, "Frequently Asked Questions," http://app1.sba.gov/faqs/faqindex.cfm?areaID=24.

[4] "Suitable terms" is a subjective assessment by the SBA lender. Even if it could get capital from a private lender, a small business can get a SBA loan so long as the SBA lender (which may even be the same bank to which the business applied for a private loan) assesses that the conditions of the private loan would be "burdensome." Because of the high probability of failure, most risky projects are likely to have private loans offered at "burdensome" terms.

[5] See Small Business Administration, "SBA's Role—Guaranty Percents," http://www.sba.gov/services/financialassistance/basics/sbarole/serv_7a_guarantyperc.html.

[6] Maurice McTigue, Henry Wray and Jerry Ellig (2007), "8th Annual Performance Report Scorecard: Which Federal Agencies Best Inform the Public?" The Mercatus Center at George Mason University, April.

[7] Small Business Administration, Congressional Submission FY2006, http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_abt_budget_2.pdf

[8] Ibid, p. 20, 24, 35.

[9] Ibid, p. 24.

[10] Ibid, p. 35.

[11] Ibid, p. 68.

[12] Joseph Stiglitz and Andrew Weiss (1981). "Credit rationing in Markets with Imperfect Information," American Economic review, Vol 71, n. 3, June.

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NATIONAL ASSOCIATION
OF GOVERNMENT GUARANTEED LENDERS

"Assessing the 7(a) Loan Program's Performance"

Testimony before the Subcommittee on Federal Financial Management, Government Information and International Security of the Senate Committee on Homeland Security and Government Affairs

November 1, 2007

Submitted by
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NAGGL Gets It.

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Mr. Chairman, Ranking Minority Member Coburn, and members of the Subcommittee, my name is Tony Wilkinson. I am president and chief executive officer of the National Association of Government Guaranteed Lenders (NAGGL), a trade association of approximately 675 banks, credit unions, and non-depository lenders who participate in the Small Business Administration's 7(a) loan guarantee program. NAGGL members generate approximately 80% of the annual SBA 7(a) loan volume.

We appreciate the opportunity to testify today on the July 2007 General Accountability Office's report, *Small Business Administration: Additional Measures Needed to Assess Loan Program's Performance*. NAGGL's September 11 letter to Senator Coburn, a copy of which is appended to my testimony, fully discusses NAGGL's views regarding the GAO report. We think the GAO did a good job in reviewing the 7(a) program and we agree with the conclusion that more measures are needed to assess the program's performance.

This is not a new viewpoint for NAGGL: the association has supported the adoption and use of 7(a) program performance measures for more than 10 years. That proposition, however, has met resistance within the executive branch, and the absence of any 7(a) reauthorization bill for the last six years has limited the ability to have performance measures required by law. NAGGL is currently working with the Senate Committee on Small Business and Entrepreneurship to develop performance measures for the program. I am hopeful language will be included in S. 1256 and that Congress will pass that bill this year.

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Mr. Chairman, the 7(a) program is often misunderstood. I would like to take a minute to address common program misperceptions. The first misperception is the belief that the program provides only a small amount of capital annually to small business. As stated in my letter to Senator Coburn, the 7(a) program is a gap lending program. The program provides approximately 35% of all long-term (i.e., greater than three years) capital annually to small business—not an inconsequential sum. It is not meant or designed to replace all other forms of lender credit to small business. It is simply incorrect to argue that the program is not doing its job or meeting a specific need. The examples of the SBA program's success are innumerable and range from small local companies like Eskimo Joe's to large conglomerates such as Nike Footwear, FedEx, and Columbia Sportswear. Each of these companies is an example of SBA loans providing stable employment, improved technology, and enhanced national productivity.

A second common misperception is that small businesses have no difficulty accessing capital. This may be true for those small businesses that require only short-term capital since lenders often will make conventional loans to small businesses on a short-term basis. But lenders dependent on short-term deposits are reluctant to make long-term loans to small business. It is imperative for small businesses to have a stable, long term financing source to meet their needs and fuel their growth. The very nature of conventional lending prevents this need from being filled. The lenders participating in the 7(a) program are able to meet this need without credit subsidy cost to the taxpayer. Again, this is discussed at length in my letter to Senator Coburn.

Associated with the erroneous belief that small businesses can easily access capital on reasonable terms and conditions, is the view that the small business capital market is reaching all needs or as some might say "well-functioning." GAO (page 5) dispels this myth: "7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. For example, 28 percent of 7(a) loans compared with an estimated 9 percent of conventional loans went to minority-owned small businesses from 2001 through 2004. In addition, 25 percent of 7(a) loans went to small business start-ups while the overall lending market served almost exclusively established firms (95 percent)."

Elsewhere (page 25) GAO reports "...SBA does track loans that go to firms in areas it considers 'underserved' by the conventional lending market. SBA defines 'underserved' by one of these federally defined areas: Historically Underutilized Business Zone, Empowerment Zone/Enterprise Community, low- and moderate-income census tract (median income of census tract no greater than 80 percent of the associated metropolitan area or non-metropolitan median income), or rural as classified by the U.S. Census. Using this measure, SBA's analysis found that 49 Percent of 7(a) approved loans and disbursed in fiscal year 2006 went to geographic areas that SBA considered 'underserved' by the conventional market."

Mr. Chairman, whether one wants to look at the demographics of who gets a 7(a) loan or to evaluate the program by it serving a long-term lending need, it is clear the 7(a) program is filling a market niche failed by conventional lending.

Mr. Chairman, whether one wants to evaluate the 7(a) program by looking at the demographics of who gets a 7(a) loan, or based on the program serving a long-term lending need, it is clear the 7(a) program is filling a market niche failed by conventional lending.

Third, some assert that SBA 7(a) lending represents credit rationing. In other words, some believe that undeserving borrowers are getting access to capital under the 7(a) program and deserving borrowers may be denied capital because of the program. The 7(a) borrower is an acceptable credit risk. The borrower may not meet the criteria for a conventional loan, but this does not mean the borrower is an undue credit risk. For example, a borrower may well qualify for a three-year conventional loan, yet, at the same time, the bank is unwilling to provide a 10 year conventional loan. The reasons for the bank's reluctance could be regulatory constraints, capital restrictions, collateral issues, internal lending parameters, or other factors independent of the borrower's credit situation. The small business borrower typically needs long-term capital to start or grow a business—not short-term loans or high interest credit card loans. Moreover, the 7(a) program crowds no small business out of the credit market. Lenders are in the business of making loans to creditworthy borrowers; however, they are not able to operate in a free market system. Lenders must mitigate the risk of their loans under the umbrella of regulatory constraints, shareholder oversight, and economic limitations. The 7(a) program bridges the market failure gap and expands the financing reach to small businesses desiring to grow.

Fourth, the assertion is often made that the 7(a) program costs the taxpayer money and that the program has an inordinately high loan default rate, yet the facts show otherwise. According to CBO and SBA, since 1992 borrowers and lenders have paid approximately $1.4 billion more in fees to the Treasury than was required by The Federal Credit

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Reform Act. That Act assures the taxpayer has no estimated liability for 7(a) loans. Only if the subsidy rate calculation fails to adequately protect the taxpayer during the loan term, is there a contingent federal liability on 7(a) loans. Given the conservative nature of the subsidy calculation combined with the excess fees paid by borrowers and lenders, the possibility of contingent federal liabilities associated with the SBA program is remote.

With respect to the concern that 7(a) loans have an inordinately high default rate, it should be noted that, according to the president's FY 2007 budget submission, the default rate on 7(a) loans is projected to be 6.96 percent for the entire 25 year life of the cohort. The annual default rate for commercial loans for FDIC-insured banks is reported at approximately 1.5 percent. While there appears to be a significant disparity, it should be noted that this is an inaccurate comparison. The 7(a) default rate represents the life of the lending pool while the commercial default rate is for one year. Credit risk relating to specific small businesses is only one factor when predicting future defaults. The long term business risk, economic risk and interest risk all contribute to the 7(a) default estimate, while the default rate for commercial banks is reduced as a result of the short-term nature of the loans. This further illustrates the need for performance standards that appropriately measure risk and provide a meaningful comparison to commercial bank and regulatory standards.

Fifth, it has been suggested that lenders are unjustly enriching themselves through participation in the 7(a) program, especially through participation in the 7(a) secondary market. With respect to this suggestion, I would simply ask "If the secondary market is such a moneymaker for lenders, then why don't all lenders participate in it? Why don't all lenders sell the guaranteed portion of their loans?" Year in and year out, 35-45 percent

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of SBA loans are sold in the secondary market. That percentage range has not changed in 25 years. Moreover, it is typically not the large financial institutions that participate in the secondary market. For example, some of the largest producers of 7(a) volume, JPMorgan Chase, Bank of America, Wells Fargo, U.S. Bank, and Wachovia do not participate in the secondary market. The lenders who do participate in the secondary market are primarily small community banks and non-depository institutions. Again, why do they participate? They participate because it allows them to fund additional loans, to readily provide additional liquidity, and to improve their (in the case of banks) regulatory ratios by generating good returns while not substantially increasing total assets. As GAO found in its earlier study, *SBA's 7(a) Guaranteed Program: An Assessment of Its Role in the Market,*: "Sales of SBA-guaranteed loans in the secondary market benefit small businesses. Lenders are able to obtain funds from investors such as insurance companies, pension funds, and money market funds which traditionally do no invest directly in small business."

Sixth, some argue that lenders, especially those that participate in the secondary market, have no interest in the quality of SBA lending and in servicing those loans. The facts speak otherwise. One frequently overlooked fact is that the program mandates that all lenders, whether they sell their loans or not, are responsible for prudent loan-making and prudent loan servicing. SBA's guarantee is a *contingent* guarantee which means that if a lender fails to fully meet its responsibilities, SBA can—and does—reduce the amount of the guarantee payment to lenders. In the most egregious cases of imprudent lending, SBA denies its liability under the guarantee. Therefore, the very nature of the guarantee relationship serves to assure that lenders engage in quality lending. Also, the guarantee program is a sharing of risk and not a complete transfer of risk away from the

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7(a) lending community. The lenders have an ongoing responsibility to their regulatory oversight group as well as to shareholders to ensure that safe and sound lending practices are maintained.

More specifically, history shows that the lending community polices itself. For example, it was the 7(a) industry that raised concerns about the Clinton administration's implementation and management of the Low Doc Program. Why? Since there were no written policies for several years after the Low Doc pilot program was implemented, the program invited participation by lenders that did not have sufficient interest in quality lending. In the 1990s, it was NAGGL that raised concerns to SBA and Congress about the practices of the industry's then largest lender. The evidence is clear: lenders and the industry do care about quality lending. Federal credit reform requires us to care because one bad lender can affect the ability of every other lender to lend; one bad lender can substantially increase the costs of other lenders and borrowers participating in the program. One bad lender can make it impossible for future borrowers to receive capital at the lowest possible cost.

Lastly, the program has been criticized for what is believed to be an over concentration of large lenders delivering an increasingly growing percentage of 7(a) loans. On a loan volume basis, meaning the absolute number of loans a lender makes, this may be correct. But in terms of the dollar volume of loans made to small business, it is incorrect. Nevertheless, NAGGL agrees that small, rural banks need to be drawn into the program. The inherent costs of entering the program, such as technology requirements to originate and service SBA loans, training and staffing needs, and the potential negative impact to a small bank's capital position if a guarantee is denied, all are barriers to a bank's desire to enter the 7(a) lending arena. We applaud the administration for its recently announced efforts to engage these banks and credit unions through the Rural Lender Advantage initiative. We look forward to working with the agency on making this initiative a success.

Moreover, the concentration of lending that causes some concern today has been created by the Express Loan program that is the fastest growing type of 7(a) loan. Used almost exclusively by money center banks, the Express program allows lenders to use their own loan documentation for 7(a) loans up to $350,000 and in return receive a reduced guarantee of 50 percent. NAGGL would be pleased to work with the authorizing committees to devise a plan to allow easier entry into and expanded utilization of Express or Express-Like programs for those smaller financial institutions that will likely never have large 7(a) portfolios.

Mr. Chairman, I appreciate the opportunity to testify today on the misconceptions surrounding the SBA 7(a) program. Thank you for your continued support of this vital economic growth program.

United States Government Accountability Office

GAO

Report to the Ranking Member, Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

July 2007

SMALL BUSINESS ADMINISTRATION

Additional Measures Needed to Assess 7(a) Loan Program's Performance

G A O
Accountability * Integrity * Reliability

GAO-07-769

July 2007

SMALL BUSINESS ADMINISTRATION

Additional Measures Needed to Assess 7(a) Loan Program's Performance

GAO Accountability·Integrity·Reliability

Highlights

Highlights of GAO-07-769, a report to the Ranking Member, Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

The Small Business Administration's (SBA) 7(a) program, initially established in 1953, provides loan guarantees to small businesses that cannot obtain credit in the conventional lending market. In fiscal year 2006, the program assisted more than 80,000 businesses with loan guarantees of nearly $14 billion.

This report examines (1) the program's purpose, based on its legislative history, and performance measures; (2) evidence of constraints, if any, affecting small businesses' access to credit; (3) the types of small businesses served by 7(a) and conventional loans; and (4) differences in SBA's estimates and reestimates of the program's credit subsidy costs. GAO analyzed agency documents, studies on the small business lending market, and data on the characteristics of small business borrowers and loans.

What GAO Recommends

GAO recommends that SBA take steps to ensure that the 7(a) program's performance measures provide information on program outcomes.

In written comments, SBA agreed with the recommendation in this report but disagreed with one comparison in a section of the report on credit scores of small businesses with 7(a) and conventional loans.

www.gao.gov/cgi-bin/getrpt?GAO-07-769.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

As the 7(a) program's underlying statutes and legislative history suggest, the loan program is intended to help small businesses obtain credit. The program reflects this intent, in part, by guaranteeing a portion of each loan, alleviating some of the lender's risk. However, determining the program's success is difficult, as the performance measures show only outputs—the number of loans provided—and not outcomes, or the fate of the businesses borrowing with the guarantee. The agency is currently undertaking efforts to develop additional, outcome-based performance measures for the 7(a) program, but is not certain when any outcome-based measures may be introduced or what they may capture.

Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit in the conventional lending market, but this evidence—which dates from the early 1970s through the early 1990s—does not account for recent developments that have occurred in the small business lending market. Several studies concluded, for example, that credit rationing—that is, when lenders do not provide loans to all creditworthy borrowers—was more likely to affect small businesses in part because these firms might not have sufficient information for lenders to assess their risk. However, the studies did not address recent significant changes to the small business lending market, such as the use of credit scoring, which may reduce the extent to which credit rationing occurs.

GAO found that 7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. A higher percentage of 7(a) loans went to minority-owned and start-up businesses compared with conventional loans from 2001 to 2004. More similar percentages of loans with and without SBA guarantees went to small businesses owned by women and those located in economically distressed neighborhoods. The characteristics of 7(a) and market loans differed in several key respects, however. For example, loans guaranteed by the 7(a) program were more likely to be larger and have variable interest rates, longer maturities, and higher interest rates.

SBA's recent reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 show that the long-term costs of these loans have generally been lower than the initial estimates. Since fiscal year 2005, initial estimates have shown a "zero credit subsidy." But the ultimate credit subsidy cost for any cohort of loans made will not be known until no loans are left outstanding. Reestimated costs may change because of uncertainties in forecasting and factors such as the number of loan defaults. Since 2002, the agency has employed an econometric model that incorporates historical data and other economic assumptions for its credit subsidy cost estimates and reestimates instead of relying primarily on predictions based on historical average loan performance.

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Abbreviations

D&B	Dun & Bradstreet Corporation
EZ/EC	Empowerment Zone and Enterprise Community
FCRA	Federal Credit Reform Act of 1990
FDIC	Federal Deposit Insurance Corporation
FIC	Fair Isaac Corporation
FSS	Financial Stress Score
GPRA	Government Performance and Results Act of 1993
PAR	Performance and Accountability Report
RC	Renewal Community
SBA	Small Business Administration
SBPS	Small Business Predictive Score
SSBF	Survey of Small Business Finances

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

July 13, 2007

The Honorable Tom Coburn, M.D.
Ranking Member
Subcommittee on Federal Financial Management,
Government Information, Federal Services, and International Security
Committee on Homeland Security and Governmental Affairs
United States Senate

Dear Dr. Coburn,

Small businesses represent more than 99 percent of American firms and employ half of all private sector employees. The Small Business Administration (SBA) was created in 1953 to assist and protect the interests of small businesses in order to preserve free competition, in part by addressing constraints in the supply of credit for these firms. SBA's 7(a) Loan Program—the agency's largest loan program for small businesses—is intended to help small businesses obtain credit that they would be unable to obtain in the conventional lending market. For example, small businesses may be unable to obtain credit from conventional lenders because these firms may lack the financial and other information that larger, more established firms can provide. By providing a loan guarantee that covers a portion of a lender's losses if a small business is no longer able to meet its loan obligations, the 7(a) program decreases the risk to the lender and may make more credit available to small businesses. In fiscal year 2006, the 7(a) program assisted slightly more than 80,000 businesses by guaranteeing loans valued at nearly $14 billion.

Loan guarantee programs can result in subsidy costs to the federal government, and the Federal Credit Reform Act of 1990 (FCRA) requires, among other things, that agencies estimate the cost of these programs—that is, the cost of the loan guarantee to the federal government. FCRA also recognizes the difficulty of estimating credit subsidy costs and acknowledges that the eventual cost of the program may deviate from initial estimates. SBA makes its best initial estimate of the 7(a) program's credit subsidy costs and revises (reestimates) the estimate annually as new information becomes available. In fiscal years 2005 and 2006, SBA estimated that the credit subsidy cost of the 7(a) program would be equal to zero—that is, the program would not require annual appropriations of budget authority for new loan guarantees. To offset some of the costs of the program, such as default costs, SBA assesses lenders two fees on each 7(a) loan. The guarantee fee must be paid by the lender at the time of loan application or within 90 days of the loan being approved, and is based on the guaranteed portion of the loan amount approved and can be passed on to the borrower.[1] The ongoing servicing fee must be paid annually by the lender and is based on the outstanding balance of the guaranteed portion of the loan.[2] In making its 2005 and later estimates, SBA adjusted the ongoing servicing fee so that the initial credit subsidy estimates would be zero based on expected loan performance.[3] Although the 7(a) loan guarantee program is intended to be a "zero credit subsidy" program, FCRA provides that higher reestimates of subsidy costs, when they occur, are funded separately.[4] According to FCRA, permanent indefinite budget authority is available to cover any higher reestimates of subsidy costs for the 7(a) loan program.[5] Thus, any reestimates exceeding the initial estimates would represent a cost to the federal government.

We have noted elsewhere the challenges that Congress faces in reexamining the appropriate role and size of many federal programs that entail costs to the federal government.[6] At your April 2006 hearing on the effectiveness of SBA, you asked what types of businesses were assisted by SBA and whether the agency's activities have measurable results for small businesses.[7] In light of the challenges facing Congress, as well as your concerns about the goals and impact of SBA's 7(a) loan program, you asked us to look into several aspects of the 7(a) loan program. Specifically, this report discusses (1) the 7(a) program's purpose, based on its underlying statutes and legislative history, and the performance measures SBA uses to assess the program's results; (2) evidence of market constraints, if any, that may affect small businesses' access to credit in the

[1]Section 7(a)(18) of the Small Business Act.

[2]Section 7(a)(23) of the Small Business Act.

[3]As authorized by section 7(a)(23)(A) of the Small Business Act.

[4]2 U.S.C. § 661c(f).

[5]Permanent, indefinite budget authority is available as a result of previously enacted legislation (in this case, FCRA) and is available without further legislative action or until Congress affirmatively rescinds the authority. The amount of the budget authority is indefinite—that is, unspecified at the time of enactment—but becomes determinable at some future date (in this case, when reestimates are made).

[6]GAO, *21st Century Challenges: Reexamining the Base of Federal Government*, GAO-05-352T (Washington, D.C.: Feb. 16, 2005).

[7]Chairman's Statement, Sen. Tom Coburn, *The Effectiveness of the Small Business Administration*, April 6, 2006.

conventional lending market; (3) the segments of the small business lending market that are served by 7(a) loans and the segments that are served by conventional loans; and (4) differences in SBA's estimates and reestimates of the 7(a) program's credit subsidy costs and the factors that may cause uncertainty about the costs of the 7(a) program to the federal government. As agreed with your office, we have also included in appendix III information on the characteristics of loans financed under SBA's 504 program, which provides long-term, fixed-rate financing for major fixed assets, such as land and buildings.[8]

To describe the purpose of the 7(a) program, we reviewed the program's underlying statutes and legislative history to understand how the program was intended to help small businesses. To assess SBA's performance measures for the 7(a) program, we examined performance and accountability reports and other related documents that describe the measures SBA uses to assess the performance of the 7(a) program and compared those performance measures to established GAO criteria for successful performance measures. We also interviewed SBA officials on the agency's efforts to improve its performance measures. To identify any evidence of constraints that could affect small businesses' access to credit, we summarized peer-reviewed studies on market imperfections in the lending market. To determine which segments of the small business lending market the 7(a) and conventional loans serve, we compared characteristics and loan terms of 7(a) borrowers to those of small business borrowers. We primarily relied on SBA data from 2001 through 2004 and on the Federal Reserve's 2003 Survey of Small Business Finances (SSBF).[9] In describing 7(a)'s credit subsidy costs, we compared SBA's original credit subsidy cost estimates for fiscal years 1992 through 2006 to SBA's most recent reestimates (as reported in the fiscal year 2008 Federal Credit Supplement) and interviewed SBA officials about the differences.[10] We

[8]504 projects consist of three sources of funds: (1) a loan backed by a 100-percent SBA-guaranteed debenture from a community development company limited to a maximum of 40 percent of the project, (2) a loan from a third party lender (usually a conventional lender), and (3) a contribution of at least 10 percent equity from the small business that is receiving the assistance.

[9]The Board of Governors of the Federal Reserve System's (Federal Reserve) SSBF is the best available data on loans made to small firms in the conventional lending market. Information in the SSBF may include some loans that were guaranteed by the 7(a) loan program.

[10]Office of Management and Budget, Federal Credit Supplement, Budget of the U.S. Government, Fiscal Year 2008 (Washington, D.C.: Feb. 5, 2007).

also reviewed SBA documents related to the 7(a) credit subsidy cost model. We conducted our work in Washington, D.C., and Chicago from May 2006 through July 2007 in accordance with generally accepted government auditing standards. Appendix I discusses our scope and methodology in further detail.

Results in Brief

The 7(a) program's design and performance measures in part reflect the program's legislative history, but the performance measures provide limited information about the impact of the loans on the small businesses receiving them. The underlying statutes and legislative history of the 7(a) program help establish the federal government's role in assisting and protecting the interests of small businesses, especially those with minority ownership. The program's performance measures focus on loan guarantees that are provided to small business owners identified in the program's authorizing statutes and legislative history. These firms include start-ups, existing small businesses, and businesses whose owners face "special competitive opportunity gaps," such as minority- or female-owned businesses. However, all of the 7(a) program's performance indicators are primarily output measures—for instance, they report on the number of loans approved and funded. As a result, no information is available on how well firms do after receiving a 7(a) loan (outcomes). The current measures do not indicate how well the agency is meeting its strategic goal of helping small businesses within these groups succeed. The agency is currently undertaking efforts to develop additional outcome-based performance measures for the 7(a) program, but agency officials said that it was not clear when any outcome-based measures might be introduced or what they might measure.

Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections, such as credit rationing, in the conventional lending market. Some studies showed, for example, that lenders might lack the information needed to distinguish between creditworthy and noncreditworthy borrowers and thus could "ration" credit by not providing loans to all creditworthy borrowers. Several studies we reviewed generally concluded that credit rationing was more likely to affect small businesses because lenders could face challenges in obtaining enough information on these businesses to assess their risk. The literature we reviewed on credit rationing relied on data from the early 1970s through the early 1990s, however, and did not account for recent trends in the small business lending market. Among these trends is the increased use of credit scoring, which provides lenders with additional information on borrowers and may have had a significant impact on the extent of credit rationing in the current conventional lending market. In addition to credit rationing, some lenders may deny credit to firms owned by specific segments of society. Though studies we reviewed noted some disparities among races and genders in the conventional lending market, the studies did not offer conclusive evidence on the reasons for those differences.

7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. For example, 28 percent of 7(a) loans compared with an estimated 9 percent of conventional loans went to minority-owned small businesses from 2001 through 2004. In addition, 25 percent of 7(a) loans went to small business start-ups, while the overall lending market served almost exclusively established firms (about 95 percent). A more similar percentage of 7(a) and conventional loans went to other segments of the small business lending market, such as businesses owned by women or located in distressed neighborhoods. Finally, the characteristics of 7(a) and conventional loans differed in several ways. For example, 7(a) loans typically were larger and more likely to have variable rates, longer maturities, and higher interest rates than conventional loans to small businesses.

SBA's most recent reestimates of the credit subsidy costs for 7(a) loans made during fiscal years 1992 through 2004 indicate that, in general, the long-term costs of these loans would be lower than initially estimated. The 7(a) program has been estimated to be a "zero credit subsidy" program since fiscal year 2005. The most recent reestimates, including those made since 2005, may change because of the inherent uncertainties of forecasting subsidy costs and the influence of economic conditions, such as interest rates on several factors, including loan defaults (which exert the most influence over projected costs) and prepayment rates. Unemployment is another factor related to the condition of the national economy that could affect the credit subsidy cost—for instance, if unemployment rises above projected levels, loan defaults are likely to increase. Beginning in 2003, the agency has moved from primarily using historical averages of loan performance data to an econometric model that incorporates historical data and other economic assumptions to project credit subsidy costs.

This report makes a recommendation to the SBA Administrator to complete and expand SBA's current work on evaluating the program's performance measures. In addition, we recommend that SBA use the loan performance information it already collects, including but not limited to defaults, prepayment rates, and the number of loans in good standing, to better report how small businesses fare after they participate in the 7(a) program.

We provided a draft of this report to SBA for review and comment. In written comments, SBA agreed with our recommendation (see app. IV). However, SBA disagreed with a comparison in the section of our report discussing credit scores of borrowers with 7(a) and conventional loans. Specifically, we reported limited differences in the credit scores of small businesses with 7(a) and conventional loans. Although stating in its letter that "the numbers have not been worked out," SBA concluded that the impact on loan defaults from the higher share of 7(a) loans in the riskier credit score categories would not be insignificant. Our analyses of credit scores and other borrower and loan characteristics was not intended to quantify the impact of differences in these characteristics on 7(a) defaults. We continue to believe that our analysis of credit scores provides a reasonable basis for comparing the scores of business in different credit score categories. Further analyses of these types are consistent with our recommendation that SBA expand its abilities to assess the overall effectiveness of the 7(a) program. In addition, SBA provided technical comments, which we incorporated into the report as appropriate.

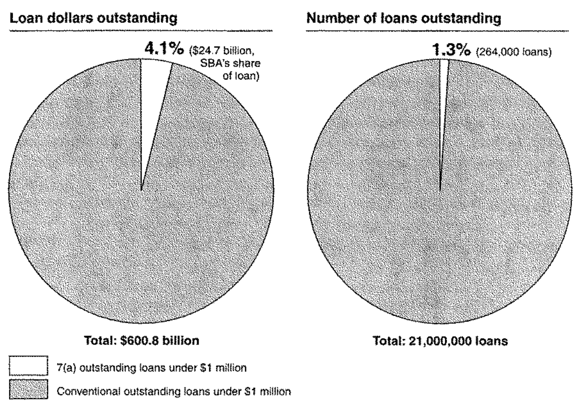
Background

Initially established in 1953, the 7(a) program guarantees loans made by commercial lenders—mostly banks—to small businesses for working capital and other general business purposes.[11] The guarantee assures the lender that if a borrower defaults on a loan, the lender will receive an agreed-upon portion (generally between 50 percent and 85 percent) of the outstanding balance. Because the guarantee covers a portion of the outstanding amount, both the lender and SBA share some of the risk associated with a potential default. SBA is not liable for the guarantee should the lender not comply materially with the program's regulations—for instance, by not paying the guarantee fee to SBA in a timely manner. As figure 1 shows, SBA's share of loans guaranteed by the 7(a) program was an estimated 4.1 percent of all outstanding small business loan dollars for loans under $1 million ($24.7 billion out of $600.8 billion). This share accounts for about 1.3 percent of the number of outstanding small business loans of under $1 million in 2005 (about 264,000 out of 21 million

[11]Section 7(a) of the Small Business Act, as amended, codified at 15 U.S.C. § 636(a); see also 13 C.F.R. Part 120. Although SBA has limited legislative authority to make direct loans to borrowers unable to obtain loans from conventional lenders, SBA has not received any funding for these programs since fiscal year 1996.

loans).[12] SBA's shares of outstanding small business loans under $1 million for the years 2003 and 2004 were similar.[13]

Figure 1: Loan Volume for 7(a) and Conventional Small Business Loans, 2005



Source GAO analysis of SBA outstanding 7(a) loan data and Office of Advocacy special tabulations of call reports (Consolidated Reports of Condition and Income for U S Banks)

SBA relies on lenders to process and service 7(a) loans and to ensure that borrowers meet the program's eligibility requirements.[14] To be eligible for

[12]To compare the number and amount of outstanding small business loans to 7(a) loans, we used SBA reports based on the Federal Deposit Insurance Corporation's (FDIC) Consolidated Reports of Condition and Income for U.S. Banks (call reports) and SBA data on outstanding 7(a) loans. In analyzing data from call reports, SBA defines a small business loan as a commercial and industrial loan for which the original amount was less than $1 million.

[13]SBA has data available to make this comparison only for 2003, 2004, and 2005.

the 7(a) loan program, a business must be an operating for-profit small firm (according to SBA's size standards) located in the United States. To determine whether a business qualifies as small for the purposes of the 7(a) program, SBA uses size standards that it has established by industry.[15] These standards set the maximum average number of employees or annual receipts that a small business may have. While SBA gives special consideration to certain groups of business owners, the program does not set aside loans for or require that a certain number of loans be made to targeted groups. Nevertheless, SBA has performance measures that track how many loans go to new small businesses and that include information on various types of businesses, such as minority-, women-, and veteran-owned firms.

In addition to making sure that borrowers meet the size requirements, lenders must certify that small businesses meet the "credit elsewhere" requirement. SBA does not extend credit to businesses if the financial strength of the individual owners or the firm itself is sufficient to provide or obtain all or part of the financing or if the business can access conventional credit. To certify borrowers as having met the credit elsewhere requirement, lenders must first determine that the firm's owners are unable to provide the desired funds from their personal resources. Second, the credit elsewhere test requires that lenders determine that the desired credit, for similar purposes and period of time, is unavailable to the firm on reasonable terms and conditions from nonfederal sources without SBA assistance, taking into consideration prevailing rates and terms in the community or locale where the firm conducts business. Nonfederal sources may include any lending institutions or a borrower's personal resources.

[14]Within the 7(a) program, there are several program delivery methods—regular 7(a), the certified lender program, the preferred lender program, SBAExpress, Community Express, Export Express, and Patriot Express. SBA provides final approval for loans made under the regular 7(a) program. Certified lenders must perform a thorough credit analysis on the loan application packages they submit to SBA so that SBA can rely on that analysis to allow it to perform a credit review only, thereby shortening the time for SBA loan processing. Preferred lenders have delegated authority to make SBA-guaranteed loans, subject only to a brief eligibility review and assignment of a loan number by SBA. Lenders participating in SBAExpress, Community Express, Export Express, and Patriot Express also have delegated authority to make SBA-guaranteed loans.

[15]In establishing size standards, SBA considers economic characteristics comprising the structure of the industry, including degree of competition, average firm size, start-up costs and entry barriers, and distribution of firms by size. It also considers growth trends, competition from other industries, and other factors that may distinguish small firms from other firms. SBA's size standards seek to ensure that a firm that meets a specific size standard is not dominant in its field of operation.

According to SBA's fiscal year 2003-2008 Strategic Plan, the agency's mission is to maintain and strengthen the nation's economy by enabling the establishment and viability of small businesses and by assisting in the economic recovery of communities after disasters. SBA describes the 7(a) program as contributing to an agencywide goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs." As reported annually in SBA's Performance and Accountability Reports (PAR), the 7(a) program contributes to this strategic goal by fulfilling each of the following three long-term, agencywide objectives: (1) increasing the positive impact of SBA assistance on the number and success of small business start-ups, (2) maximizing the sustainability and growth of existing small businesses that receive SBA assistance, and (3) significantly increasing successful small business ownership within segments of society facing special competitive opportunity gaps. Groups facing these special competitive opportunity gaps include those that SBA considers to own and control little productive capital and to have limited opportunities for small business ownership (such as African Americans, American Indians, Alaska Natives, Hispanics, Asians, and women) and those that are in certain rural or low-income areas. The 7(a) program has nine performance measures. For each of its three long-term objectives, SBA collects and reports on (1) the number of loans approved, (2) the number of loans funded (i.e., money that was disbursed), and (3) the number of firms assisted.

To report on its performance measures, SBA collects data from lenders. Loan-level data for the 7(a) program are housed in the Loan Accounting System. This system contains data describing the loan, such as the percentage of the loan guaranteed by SBA, the number of months to maturity, and the interest rate (fixed or variable). The data also include information on the small firm, such as the ethnicity and gender of the principal owner, the number of employees, and the firm's status as "new" (i.e., less than 2 years old). Furthermore, the system contains data on the loan's status—for example, whether the loan has been purchased by SBA (i.e., is in default), has been prepaid, or is in good standing.

According to provisions in FCRA, at the time a guaranteed loan is made, the credit subsidy cost is financed with the program's annual appropriations. Also under FCRA, SBA makes annual revisions (reestimates) of credit subsidy costs for each cohort of loans made during a given fiscal year using new information about loan performance, revised expectations for future economic conditions and loan performance, and improvements in cash flow projection methods. These reestimates represent additional costs or savings to the government and are recorded in the budget. FCRA provides permanent indefinite budget authority for any reestimated increases of credit subsidy costs (upward reestimates) that occur after the year in which a loan is disbursed. Reestimated reductions of subsidy costs (downward reestimates) are credited to the Treasury and are unavailable to the agency. In addition, FCRA does not count administrative expenses against the appropriation for credit subsidy costs. Instead, administrative expenses are subject to separate appropriations and are recorded each year as they are paid, rather than as loans are originated.

Though Incorporating Policy Objectives from the 7(a) Program's Legislative History, 7(a)'s Performance Measures Do Not Gauge the Program's Impact on Participating Firms

The performance measures for the 7(a) program incorporate the various policy objectives described in the program's underlying statutes and legislative history but do not assess the impact of the loan guarantees on small businesses receiving loans. We compared criteria for the characteristics of effective performance measures and found that the 7(a) performance measures incorporated several of these attributes. For example, the performance measures track the main activity of the 7(a) program by identifying the number of loans that are approved for small firms that have been unable to obtain credit in the conventional lending market. However, the performance measures do not show whether the program is meeting the agency's goal of improving the success of small firms that participate in the program. None of the 7(a) performance measures provide information on how well firms do after they have received a loan. SBA has been undertaking efforts to develop additional performance measures to describe the program's impact on participating firms. But the agency has yet to define specific outcome-based performance measures and does not have a time line for implementing such measures.

The 7(a) Program's Legislative History Emphasizes the Program's Role in Meeting Credit Needs of Certain Small Businesses

The 7(a) program's underlying statutes and legislative history have helped establish the federal government's role in assisting and protecting the interests of small business, taking into account the importance of these businesses to the overall functioning of the national economy. The legislative basis for the 7(a) program recognizes that the conventional lending market is the principal source of financing for small businesses and that the loan assistance that SBA provides is intended to supplement rather than compete with that market. However, as the legislative history suggests, conventional lending may not be a feasible financing option for some small businesses under certain circumstances. For example, conventional lenders may be unwilling to make loans when the risk of a small business is difficult to assess—for instance, when they believe that the small business has insufficient assets or specialized inventory and equipment or lacks a credit history, as in the case of a start-up. In addition, the loan terms offered to a small business in the conventional lending market may not be practical—for example, a small business may need loans with longer-term maturities than conventional lenders may be willing to provide.

The design of the 7(a) program is consistent with the program's underlying statutes and legislative history in that SBA collaborates with the conventional market in identifying and supplying credit to small businesses in need of assistance. Specifically, the 7(a) program has three design features that help it address concerns identified in its legislative history. First, the loan guarantee, which plays the same role as collateral, limits the lender's risk in extending credit to a small firm that may not have met the lender's own requirements for a conventional loan. According to SBA officials, a lender's willingness to underwrite the loan only with the guarantee confirms that the 7(a) program fills a credit gap. Second, the "credit elsewhere" requirement is intended to provide some assurance that guaranteed loans are offered only to firms that are unable to access credit on reasonable terms and conditions in the conventional lending market. Lenders follow SBA policies and procedures in determining whether a small business fulfills this key 7(a) program requirement. SBA officials explained that the agency is currently reviewing how lenders apply the credit elsewhere requirement, though the results of this review are not yet complete. Third, an active secondary market for the guaranteed portion of a 7(a) loan allows lenders to sell the guaranteed portion of the loan to investors, providing additional liquidity that lenders can use for additional loans.

Numerous amendments to the Small Business Act and to the 7(a) program have laid the groundwork for broadening small business ownership among certain groups, including veterans, handicapped individuals, women, African Americans, Hispanics, Native Americans, and Asians. The 7(a) program also includes provisions for extending financial assistance to small businesses that are located in urban or rural areas with high proportions of unemployed or low-income individuals or that are owned by low-income individuals. The program's legislative history highlights its role in helping small businesses, among other things, get started, allowing existing firms to expand, and enabling small businesses to develop foreign markets for their products and services.

The 7(a) Program's Performance Measures Are Related to the Program's Core Activity, but Do Not Provide Information on Its Impact on Participating Firms

We stated in earlier work that a clear relationship should exist between an agency's long-term strategic goals and its program's performance measures.[16] Outcome-based goals or measures showing a program's impact on those it serves should be included in an agency's performance plan whenever possible. Most plans typically supplement outcome goals with output goals showing the number and type of services provided because the program may not meet an outcome goal in the year covered by the plan. In some cases, a goal may be too difficult to measure. In previous work, we have also identified specific attributes of successful performance measures.[17] For example, each performance measure should have a measurable target and explicit methodology showing how that target was determined. Without a measurable target, an organization may be unable to determine whether it is meeting its goals. Table 1 provides a detailed description of these key attributes and discusses the potentially adverse consequences of not incorporating them into performance measures.

Table 1: Attributes of Successful Performance Measures

Attribute	Definitions	Potentially adverse consequences of not meeting attribute
Core program activity	Measure covers the activities that an entity is expected to perform in support of the program's intent.	Managers and stakeholders may not have enough information in core program areas.
Measurable target	Measure has a numerical goal.	It may be impossible to determine whether a program's performance is meeting expectations.
Reliability	Measure produces the same result under similar conditions.	Reported performance data are inconsistent and uncertainty exists about them.
Clarity	Measure is clearly stated and the name and definition are consistent with the methodology used to calculate it.	Data could be misleading to users and not capture what is intended to be measured.
Objectivity	Measure is reasonably free from significant bias or manipulation.	Performance assessments may be systematically over- or understated.
Linkage	Measure is aligned with division and agencywide goals and mission.	Behaviors and incentives created by measures do not support achieving division or agencywide goals or mission.

Source: GAO-03-143.

[16]Some earlier work includes GAO, *Executive Guide: Effectively Implementing the Government Performance and Results Act*, GAO/GGD-96-118 (Washington, D.C.: June 1996) and GAO, *The Results Act: An Evaluator's Guide to Assessing Agency Annual Performance Plans*, GAO/GGD-10.1.20 (Washington, D.C.: April 1998).

[17]GAO, *Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures*, GAO-03-143 (Washington, D.C.: Nov. 12, 2002).

We reviewed SBA's performance measures for the 7(a) loan program and found that the measures generally exhibited all of the traits described above, except for the measurable target and linkage attribute. According to SBA's fiscal year 2006 PAR, the nine performance measures were:

1. number of new loans approved to start-up small businesses,
2. number of new loans funded to start-up small businesses,
3. number of start-up small businesses assisted,
4. number of new loans approved to existing small businesses,
5. number of new loans funded to existing small businesses,
6. number of existing small businesses assisted,
7. number of new loans approved to small businesses facing special competitive opportunity gaps,
8. number of new loans funded to small businesses facing special competitive opportunity gaps, and
9. number of small businesses facing special competitive opportunity gaps assisted.

All nine performance measures we reviewed provided information that related to the 7(a) loan program's core activity, which is to provide loan guarantees to small businesses. In particular, the indicators all provided the number of loans approved, loans funded, and firms assisted by subgroups of small businesses the 7(a) program is intended to assist. As stated earlier, the program's legislative history indicates that SBA's specific lending objectives include stimulating small business in distressed areas, promoting small businesses' contribution to economic growth, and promoting minority enterprise opportunity. Consequently, SBA has developed performance measures that specifically track how many guaranteed loans go to those small business owners that the agency refers to collectively as facing special competitive opportunity gaps. Similarly, SBA separately tracks loan data regarding start-up small businesses, another group that the 7(a) program's legislative history specifically cites as having challenges in obtaining credit within the conventional lending market.

As table 2 shows, in 2004 and 2005 SBA generally met or exceeded its goals for the number of loans approved for start-ups, existing small businesses, and businesses facing special competitive opportunity gaps. In 2006, SBA did not meet any of its targets for these measures. However, while the 7(a) program did not meet its targets, it approved slightly more than 90 percent of the loans that it had set as its goal. SBA also did not always meet its target for the number of firms assisted. In years when SBA did not meet these targets, the 7(a) program again met almost 90 percent of its goal for firms assisted. Though it is not clear why SBA did not meet these targets, SBA's fiscal year 2006 PAR suggests that there may have been less demand for 7(a) loans. In addition, SBA officials explained that the agency did not make loans to small businesses directly and therefore had less control over the number of loans made. Instead, the agency relies primarily on marketing and community outreach to inform both lenders and prospective borrowers about the 7(a) program. Furthermore, SBA officials explained that the 7(a) program staff leverages other SBA offices, such as those that offer technical assistance to small businesses, to further raise the awareness among the general public and potential lenders about the 7(a) program.

Table 2: 7(a) Performance Measure Targets and Results, 2004-2006

	Fiscal year					
	2004		2005		2006	
Performance measures	**Target**	**Result**	**Target**	**Result**	**Target**	**Result**
Number of loans approved						
Start-up small business	18,000	18,134	22,671	29,587	33,024	32,983
Existing small business	72,000	62,999	65,305	66,313	73,536	64,307
Small business facing special competitive opportunity gap	44,617	60,787	68,621	74,307	76,690	71,326
Number of firms assisted						
Start-up small business	18,000	15,351	22,671	25,086	28,224	27,368
Existing small business	72,000	53,544	65,305	57,296	62,144	52,935
Small business facing special competitive opportunity gap	44,617	52,075	68,621	64,390	64,377	60,691

Source: GAO analysis of SBA's fiscal years 2006 and 2007 Budget Request and Performance Plan and fiscal year 2006 PAR

By having quantifiable goals, all of the performance measures partly met our criterion for having a measurable target attribute. SBA annually reports performance measure data, publishing goals in the agency's annual Budget Request and Performance Plan for the upcoming fiscal year and results for the preceding fiscal year in its PAR.

Though having measurable targets is a positive attribute, the PAR does not contain information about how SBA set its goals. According to SBA officials, the actual targets set for all of the measures related to the 7(a) program are based on historical data. SBA officials explained that the number of loans approved is calculated by dividing the amount appropriated for loan guarantees in a given fiscal year by the previous fiscal year's average loan amount, producing a target for the number of loans approved. SBA also measures the number of loans funded and firms assisted, both of which closely track the number of loans approved. According to SBA officials, both of these measures are always slightly lower than the number of loans approved because not all approved loans are funded and the number of firms assisted does not include multiple loans to the same firm in a given fiscal year.

In addition, the 7(a) program's performance measures are generally reliable, clearly defined, and objective. Our assessment of SBA's databases that contain information on the agency's performance measures concluded that these data were sufficiently reliable for the purposes of evaluating key loan characteristics. Additionally, most of the measures are clearly described in the SBA documents that addressed the 7(a) program's performance measures, since each performance measure's name is also its definition. Finally, the performance measures are objective and generally free from any biases, in part because they simply report the overall annual volume (i.e., outputs) of guaranteed lending business.

Since all of the 7(a) program's performance measures are primarily output measures—that is, they report on the number of loans approved and funded and firms assisted—SBA does not collect any information that discusses how well firms are doing after receiving a 7(a) loan (outcomes). Further, none of the measures link directly to SBA's long-term objectives. As a result, the performance measures do not fully support SBA's strategic goal to "increase small business success by bridging competitive opportunity gaps facing entrepreneurs." We noted in 1999 that SBA relies on output measures, such as an increase in the number of loans, but does not show how these measures are related to increasing opportunities for small businesses to be successful—SBA's main goal.[18] SBA's Inspector General also concluded in a 2000 report that most 7(a) performance measures were output based and did not provide information showing the extent to which the program was accomplishing its mission under the Small Business Act.[19] SBA management concurred with the Inspector General's conclusion and recommendations, including that the agency develop performance measures to gauge outcomes and goals for meeting

[18]GAO, *Managing for Results: Opportunities for Continued Improvements in Agencies' Performance Plans*, GAO/GGD/AIMD-99-215 (Washington, D.C.: July 20, 1999).

[19]Small Business Administration Inspector General, *Results Act Performance Measurement for the 7(a) Business Loan Program*, Report No. 1-01 (Washington, D.C.: December 2000).

the requirements set forth in the Government Performance and Results Act of 1993 (GPRA).

SBA is Working to Gauge the 7(a) Program's Impact on Participating Firms

SBA officials have recognized the importance of developing performance measures that better assess the 7(a) program's impact on the small firms that receive the guaranteed loans. SBA is expecting a final report in the summer of 2007 from the Urban Institute, which has been contracted to undertake several evaluative studies of several programs, including 7(a), that provide financial assistance to small businesses. Components of this work include assessing potential duplication of SBA's main financial assistance programs by state or local programs, establishing a baseline measure of SBA customer satisfaction, and interviewing participating lenders about their underwriting practices. One component of the study that will not be undertaken is an analysis to determine how outcomes for firms assisted through financial assistance programs, such as 7(a), would differ in the absence of SBA assistance. The impact study, as designed by the Urban Institute, required the use of credit scores for firms that did not receive SBA assistance.[20] Though costs associated with this component of the study initially prohibited SBA from undertaking it, SBA officials explained that they were advised that they are legally prohibited from obtaining credit score data from firms with which they have no relationship.

SBA officials explained that no formal decision had yet been made about how the agency might alter or enhance the current set of performance measures to provide more outcome-based information related to the 7(a) program, for several reasons. These included the agency's reevaluation of its current strategic plan in response to GPRA's requirement that agencies reassess their strategic plans every 3 years, a relatively new administrator who may make changes to the agency's performance measures and goals, and the cost and legal constraints associated with the Urban Institute study.[21] However, SBA already collects information showing how firms are faring after they obtain a guaranteed loan. In particular, SBA regularly collects information on how well participating firms are meeting their loan

[20]Small business credit scores are a range of numeric values derived using a mathematical model that takes into account information from consumer credit bureaus and business performance data from lenders. The scores attempt to predict the likelihood that a business will repay a loan.

[21]5 U.S.C. 306(b).

obligations. This information generally includes, among other things, the number of firms that have defaulted on or prepaid their loans—data that can serve as reasonable proxies for determining a firm's financial status. Though this information provides some indication of how successful firms are after receiving a 7(a) guaranteed loan, the agency primarily uses the data only to estimate some of the costs associated with the program and for internal reporting purposes, such as monitoring participating lenders and analyzing its current loan portfolio. Expanding uses of this information as part of its performance measures could provide SBA and others helpful information for describing the financial status of firms that have been assisted by the 7(a) program.

Limited Evidence Suggests That Certain Market Imperfections May Restrict Access to Credit for Some Small Businesses

Limited evidence from economic studies suggests that some small businesses may face constraints in accessing credit because of imperfections, such as credit rationing, in the conventional lending market. But this evidence is based on data that end with the early 1990s and do not account for developments that have occurred in the small business lending market since then. We focused on evidence of credit rationing reported in academic studies published in peer-reviewed journals.[22] With some exceptions, the studies we reviewed generally concluded that credit rationing was more likely to exist when there was a lack of information about the borrower—for example, with small businesses—and that the effect of this type of credit constraint on the national economy was not likely to be significant. However, the research on credit rationing was limited by at least two factors. First, researchers do not all use a similar definition for credit rationing. Second, as we have noted the studies we reviewed did not consider recent developments in the small business lending market, such as the increasing use of credit scores, that may reduce credit rationing. Finally, though researchers have noted disparities in lending options among different races and genders, inconclusive evidence exists as to whether discrimination explains these differences.

Studies We Reviewed Provide Limited Evidence of Credit Rationing

We found limited information that credit constraints, such as credit rationing, could have some effect on small businesses. Credit rationing, or denying loans to creditworthy individuals and firms, generally stems from

[22]Appendix II identifies and provides information on the studies we reviewed, including their objectives, data, methodologies, limitations, and conclusions.

lenders' uncertainty or lack of information regarding a borrower's ability to repay debt. Economic reasoning suggests that there exists an interest rate (i.e., the price of the loan) beyond which banks will not lend, even though there may be creditworthy borrowers willing to accept a higher interest rate.[23] Because the market interest rate will not climb high enough to convince lenders to grant credit to these borrowers, these applicants will be unable to access credit and will also be left out of the lending market.[24] Of the studies we identified that empirically looked for evidence of credit rationing within the conventional U.S. lending market, almost all provided some evidence consistent with credit rationing.[25] For example, one study found evidence of credit rationing across all sizes of firms.[26] However, another study suggested that the effect of credit rationing on small firms was likely small, and another study suggested that the impact on the national economy was not likely to be significant.[27] Specifically, one of these two studies, which used data on small businesses, concluded that though crediting rationing was associated with firm size, it was economically unimportant to the small businesses within their dataset.[28] Only one study that we reviewed found no evidence of credit rationing, though it could not rule out the existence of this market imperfection.[29]

[23]For more details on how economic theory predicts credit rationing, see J. E. Stiglitz and A. Weiss, "Credit Rationing in Markets with Imperfect Information," *The American Economic Review*, vol. 71, no. 3 (1981).

[24]However, under certain circumstances, economic reasoning suggests that lack of information about certain types of borrowers could result in the opposite—an excess of credit. See D. De Meza and D.C. Webb, "Too Much Investment: A Problem of Asymmetric Information," *The Quarterly Journal of Economics*, vol. 102, no. 2 (1987).

[25]We also identified additional studies that examined evidence for credit rationing between lenders and borrowers, but these studies were all based on data from foreign countries.

[26]S.J. Perez, "Testing for Credit Rationing: An Application of Disequilibrium Econometrics," *Journal of Macroeconomics*, vol. 20, no. 4 (1998).

[27]A.R. Levison and K.L. Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S.," *Small Business Economics*, vol. 14, no. 2 (2000) and A.N. Berger and G.F. Udell, "Some Evidence on the Empirical Significance of Credit Rationing," *The Journal of Political Economy*, vol. 100, no. 5 (1992).

[28]Levinson and Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S.," 90.

[29]Berger and Udell, "Some Evidence on the Empirical Significance of Credit Rationing," 1076.

In some studies we reviewed, we also found that researchers used different definitions of credit rationing and that a broader definition was more likely to yield evidence of the existence of credit rationing than a narrower definition. For example, one study defined a firm as being credit rationed if the firm was either denied a loan or discouraged from applying for credit.[30] However, another study pointed out that firms could be denied credit for reasons other than credit rationing, such as not being creditworthy.[31] Because the underlying reason for having been denied credit can be difficult to determine, true credit rationing is difficult to measure.

Other studies of small business lending that we reviewed found evidence for credit rationing by testing whether the circumstances of denial were consistent with a "credit rationing" explanation, such as a lack of information. For example, two studies concluded that having a preexisting relationship with the lender had a positive effect on the borrower's chance of obtaining a loan.[32] The empirical evidence from another study suggested that lenders use information accumulated over the duration of a financial relationship with a borrower to define loan terms. This study's results suggested that firms with longer relationships received more favorable terms—for instance, they were less likely to have to provide collateral. Because having a relationship with a borrower would lead to the lender's having more information, the positive effect of a preexisting relationship is consistent with the theory behind credit rationing.[33]

Aside from credit rationing, lenders could potentially deny creditworthy firms a loan because of the race or gender of the owner. This practice would also constitute a market imperfection because lenders would be denying credit for reasons other than interest rate or another risk associated with the borrower. A 2003 survey of small businesses

[30] J. Berkowitz and M.J. White, "Bankruptcy and Small Firms' Access to Credit," *The RAND Journal of Economics*, vol. 35, no. 1 (2004).

[31] Levinson and Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S.," 90.

[32] M.A. Petersen and R.G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *The Journal of Finance*, vol. 49, no. 1 (1994) and R. A. Cole, "The Importance of Relationships to the Availability of Credit," *Journal of Banking and Finance*, vol. 22 (1998).

[33] A.N. Berger and G.F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *The Journal of Business*, vol. 68, no. 3 (1995).

conducted by the Federal Reserve examined differences in credit use among racial groups and between genders. The survey found that differences did not exist across all comparison groups.[34] For example, the survey found that 48 percent of small businesses owned by African Americans and women and 52 percent of those owned by Asians had some form of credit, while 61 percent of white-owned or Hispanic-owned businesses had some form of credit.[35]

Studies have attempted to determine whether such disparities are due to discrimination, but the evidence from the studies we reviewed was inconclusive. For example, one study found evidence that discrimination existed against Hispanics and Asians, but not against African Americans and women.[36] A different study that was able to control for the effects of a variety of variables, such as whether the borrower had experienced bankruptcy and the borrower's credit score, found some evidence of discrimination against African Americans and women, but not against other minorities.[37] Finally, a third study found significant evidence that only firms owned by African Americans faced obstacles in obtaining credit and were charged higher interest rates, while the study did not find significant evidence that other minority- and women-owned firms face discrimination.[38]

The Literature Does Not Address Recent Trends in the Small Business Lending Market

The studies we reviewed regarding credit rationing used data from the early 1970s through the early 1990s and thus did not account for several recent trends that may have impacted the extent of credit rationing within the small business lending market. According to a Federal Reserve report on the availability of credit for small businesses, lenders are increasingly using credit scores in loan decisions involving small businesses. Credit

[34]T.L. Mach, and J.D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin* Oct.: A167-A195 (2006).

[35]The survey question specifically asked respondents about having a credit line, loan, or capital lease.

[36]K.S. Cavalluzzo and L.C. Cavalluzzo, "Market Structure and Discrimination: The Case of Small Businesses," *Journal of Money, Credit and Banking*, vol. 30, no. 4 (1998).

[37]K.S. Cavalluzzo, L.C. Cavalluzzo, and J.D. Wolken, "Competition, Small Business Financing, and Discrimination: Evidence from a New Survey," *Journal of Business*, vol. 75, no. 4 (2002).

[38]D.G. Blanchflower, P.B. Levine, and D.J. Zimmerman, "Discrimination in the Small-Business Credit Market," *The Review of Economics and Statistics*, vol. 85, no. 4 (2003).

scores provide additional information about borrowers and may reduce the cost to lenders of evaluating the risk potential borrowers present. As a result, credit scores may decrease the extent to which credit rationing occurs. Further, our economic literature review identified one study suggesting that the recent changes in bankruptcy laws may also impact the small business lending market because loans to small businesses are often secured by personal credit. Specifically, the change in bankruptcy laws that occurred in October 2005 may have made it more difficult for some individuals to declare bankruptcy and thus decreased the risk to lenders, making lenders more willing to extend credit. In addition, because it has become harder to declare bankruptcy, potential borrowers may be less likely to apply for a loan. These trends may also lead to less credit rationing in the conventional lending market. Finally, considerable consolidation has taken place in the banking industry and may have led to a decrease in the number of small banks. Historically, smaller banks have been more involved with small business lending because of the relationships between small local banks and local firms. As noted previously, relationships with lenders can limit credit rationing. With the potential decline in the number of small banks, these relationships may diminish, possibly leading to more credit rationing.

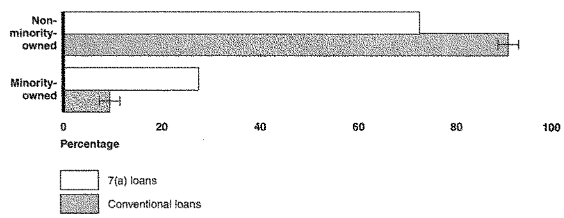
A Higher Percentage of 7(a) Loans Went to Certain Segments of the Small Business Lending Market, but Conventional Loans Were Widely Available

7(a) loans went to certain segments of the small business lending market in higher proportions than conventional loans. From 2001 to 2004, a higher percentage of 7(a) loans went to minority-owned and start-up businesses compared with conventional loans. However, more similar percentages of loans with and without SBA guarantees went to small businesses owned by women and those located in economically distressed neighborhoods. The characteristics of 7(a) and market loans differed in several key respects. For example, loans guaranteed by the 7(a) program were more likely to be larger and have variable interest rates, longer maturities, and higher interest rates.

Higher Proportion of 7(a) Loans Went to Minority-Owned and Start-Up Small Businesses

From 2001 to 2004, minority-owned small businesses received a larger share of 7(a) than conventional loans. More than a quarter of 7(a) loans went to small businesses with minority ownership, compared with an estimated 9 percent of conventional loans (fig. 2). However, in absolute numbers many more conventional loans went to the segments of the small business lending market we could measure, including minority-owned small businesses, than loans with 7(a) guarantees. For example, if we apply the percentage of 7(a) loans going to minority-owned firms (28 percent) from 2001 through 2004 to the number of outstanding 7(a) loans under $1 million in 2004 (223,939), an estimated 62,000 of these outstanding 7(a) loans went to minority-owned small firms. In comparison, if we apply the percentage of conventional loans going to minority-owned firms over the same period (9 percent) to the number of outstanding loans under $1 million in 2004 (17.13 million), we estimate that there were more than 1.6 million outstanding loans to minority-owned small businesses in June 2004.

Figure 2: Percentage of 7(a) and Conventional Loans by Minority Status of Ownership, 2001-2004



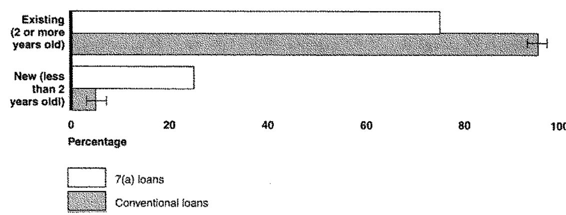
Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent confidence intervals. Because the data from the SSBF are from a probability survey based on random selections, this sample is only one of a large number of samples that might have been drawn. Since each sample could have provided different estimates, we express our confidence in the precision of the particular results as a 95 percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. As a result, we are 95 percent confident that each of the confidence intervals in this report will include the true values in the study population. Data on SBA 7(a) loans do not have confidence intervals because we obtained data on all the loans SBA approved and disbursed from 2001 to 2004.

Compared with conventional loans, a higher percentage of 7(a) loans went to small start-up firms from 2001 through 2004 (fig. 3).[39] Specifically, 25 percent of 7(a) loans went to small business start-ups from 2001 through 2004. In contrast, an estimated 5 percent of conventional loans went to newer small businesses over the same period.

[39]SBA officials explained that the agency defines start-up businesses as businesses in operation for less than 2 years. To make the data on conventional loans from the SSBF comparable to the SBA data, we defined a business with a conventional loan as a start-up if the business had been in operation for less than 2 years when the firm applied for the most recently approved loan.

Figure 3: Percentage of 7(a) and Conventional Loans by Status as a New Business, 2001-2004



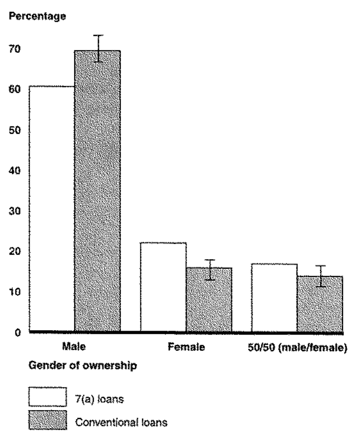
Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95 percent confidence interval.

More Similar Proportions of 7(a) and Conventional Loans Served Other Segments of the Small Business Lending Market

Compared with the differences in the shares of 7(a) and conventional loans going to minority-owned and start-up small businesses, only limited differences exist between the shares of 7(a) and conventional loans that went to other types of small businesses from 2001 through 2004. For example, the share of 7(a) loans going to small women-owned firms was much closer to the estimated share of conventional loans going to these firms. Specifically, women-owned firms received 22 percent of all 7(a) loans and an estimated 16 percent of conventional loans (fig. 4). Furthermore, the percentages of loans going to firms owned equally by men and women were also more similar—17 percent of 7(a) loans and an estimated 14 percent of conventional loans (see fig. 4). However, these percentages are small compared with those for small firms headed by men, which captured most of the small business lending market from 2001 to 2004. These small businesses received an estimated 70 percent of conventional loans and 61 percent of 7(a) loans.

Figure 4: Percentage of 7(a) and Conventional Loans by Gender of Ownership, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95 percent confidence interval.

Similarly, compared with the differences in the shares of 7(a) and conventional loans going to minority-owned and start-up small businesses, relatively equal shares of 7(a) and conventional loans reached small businesses in economically distressed neighborhoods (i.e., zip code areas) from 2001 through 2004—14 percent of 7(a) loans and an estimated 10 percent of conventional loans.[40] In order to apply a single measure uniformly across the country, we based our measure on the minimum poverty level eligibility requirement employed by two federal programs

[40]The confidence interval for the estimate of the share of conventional loans that went to small businesses in economically distressed neighborhoods (10 percent) is 7.9 to 11.7 percent.

designed to assist distressed communities.[41] Specifically, we defined distressed neighborhoods as zip code areas where at least 20 percent of the population had incomes below the national poverty line (see app. I for more information on our methodology).

SBA does not specifically report whether a firm uses its 7(a) loan in an economically distressed neighborhood. Nevertheless, SBA does track loans that go to firms located in areas it considers "underserved" by the conventional lending market. SBA defines an "underserved" area as any one of these federally defined areas: Historically Underutilized Business Zone, Empowerment Zone/Enterprise Community, low- and moderate-income census tract (median income of census tract is no greater than 80 percent of the associated metropolitan area or nonmetropolitan median income), or rural as classified by the U.S. Census.[42] Using this measure, SBA's analysis found that 49 percent of 7(a) loans approved and disbursed in fiscal year 2006 went to geographic areas that SBA considered "underserved" by the conventional lending market.

Although a higher proportion of 7(a) loans went to smaller firms (that is, firms with up to 5 employees), we found that the differences in the shares of 7(a) and conventional loans were more similar for categories of larger firms that have 5 or more employees. Specifically, 57 percent of all 7(a) loans went to small businesses with up to 5 employees, compared with the estimated 42 percent of conventional loans that went to firms with a similar number of employees. In contrast, firms with 5 to 9 employees received 21 percent of the 7(a) loans and 24 percent of conventional loans, and firms with 10 to 19 employees received 12 percent of 7(a) loans and 17 percent of conventional loans. Firms with 20 to 499 employees (the maximum number of employees a business can have and still be

[41] The Empowerment Zone/Enterprise Community program (EZ/EC) and Renewal Community program (RC) target federal grant monies to public and private entities, tax benefits to businesses, or both in order to improve conditions in competitively selected, economically distressed communities. For an area to be eligible for these programs at least 20 percent of the population in the census tracts that make up the area must have incomes below the national poverty line.

[42] A Historically Underutilized Business Zone is an area located in one or more qualified census tracts, qualified nonmetropolitan counties, or lands within the external boundaries of an Indian reservation.

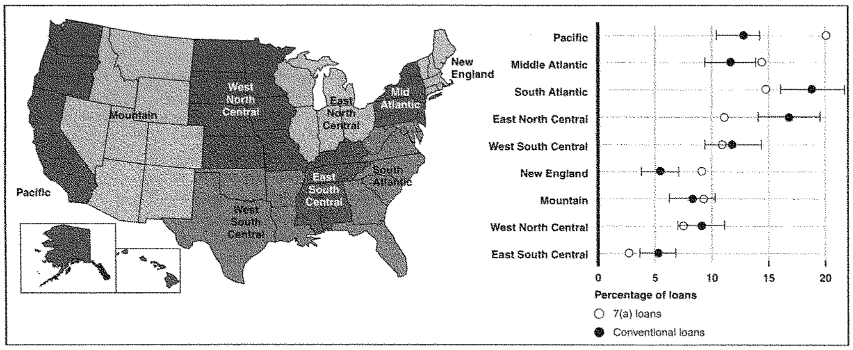
considered small by SBA's standards) also received more similar shares of 7(a) and conventional loans.[43]

More similar proportions of 7(a) and conventional loans also went to small businesses with different types of organizational structures and in different geographic locations. For instance, between 2001 and 2004 most 7(a) loans (69 percent) and most conventional loans (an estimated 60 percent) went to corporations.[44] Additionally, similar shares of 7(a) loans (28 percent) and conventional loans (approximately 32 percent) went to sole proprietorships. Similar percentages of 7(a) and conventional loans went to small firms across geographic locations (based on the nine Census divisions). The central regions of the country (e.g., Mountain, West North Central, and West South Central) received the most similar shares of 7(a) and conventional loans (fig. 5).

[43]The maximum number of employees a business can have and still be considered small varies from industry to industry, but the most common standard is 500 employees. The confidence interval for the estimate of the share of conventional loans that went to small businesses with up to 5 employees (42 percent) is 38.0 to 45.2 percent, for businesses with 5 to 9 employees (24 percent) is 21.2 to 27.5 percent, and for businesses with 10 to 19 employees (17 percent) 14.0 to 19.7 percent.

[44]The confidence interval for the estimate of the share of conventional loans that went to small businesses organized as corporations (60 percent) is 56.2 to 63.5 percent, and those organized as sole proprietorships (32 percent) is 28.2 to 35.3 percent.

Figure 5: Percentage of 7(a) and Conventional Loans by Census Divisions, 2001-2004



Sources GAO analysis of SBA data. Art Explosion (map)

Note: The brackets on the conventional loans represent a 95 percent confidence interval.

Our analysis of information on the credit scores of small businesses that accessed credit without SBA assistance showed only limited differences in these credit scores and those of small firms that received 7(a) loans. As reported in a database developed by two private business research and information providers, The Dun & Bradstreet Corporation and Fair Isaac Corporation (D&B/FIC), the credit scores we compared are typically used to predict the likelihood that a borrower, in this case a small business, will repay a loan.[45] In our comparison of firms that received 7(a) loans and those that received conventional credit, we found that for any particular credit score band (e.g., 160-<170) the differences were no greater than 5 percentage points and the average difference for these credit score bands was 1.7 percentage points (see fig. 6). More credit scores for 7(a) borrowers were concentrated in the lowest (i.e., more risky) bands compared with general borrowers, but most firms in both the 7(a) and the

[45]The portfolio management score used by SBA is the Small Business Predictive Score (SBPS). The SBPS is based on consumer and business data, and assigns small businesses with scores in the absolute range of 1 to 300, but the practical range of 50 to 250. A lower score generally indicates a greater likelihood of repayment risk, while a higher score indicates a greater likelihood that the loan will be repaid.

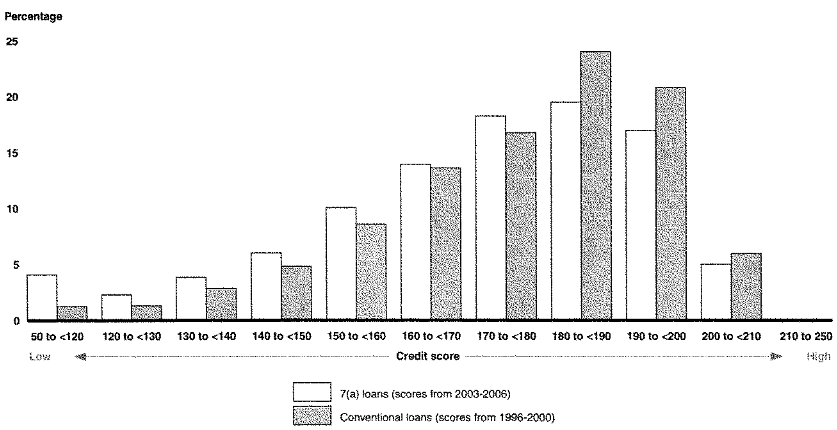
D&B/FIC portfolios had credit scores of between 170 and 200. Finally, the percentage of firms that had credit scores in excess of 210 was less than 1 percent for both groups.

The results of our analysis of credit scores should be interpreted with some caution. First, the time periods for the two sets of credit scores are different. Initial credit scores for businesses receiving 7(a) loans in our analysis are from 2003 to 2006.[46] The scores developed by D&B/FIC for small businesses receiving conventional credit are based on data from 1996 through 2000 that include information on outstanding loans that may have originated during or many years before that period.[47] Second, D&B/FIC's scores for small businesses receiving conventional loans may not be representative of the population of small businesses. Although D&B/FIC combined hundreds of thousands of financial records from many lenders and various loan products with consumer credit data for their credit score development sample, they explained that the sample was not statistically representative of all small businesses.

[46]SBA says it first received SBPS credit scores for the outstanding 7(a) loans in its portfolio in March 2003. Since then, SBA has received an initial score, known as the Surrogate Origination Score, for a 7(a) loan 1 to 4 months after the loan is disbursed. SBA subsequently has received SBPS scores on a quarterly basis for almost all of the active loans in its portfolio. We obtained data for all 7(a) loans approved and disbursed from 2001 through 2005, so the dates of the initial credit scores ranged from 2003 to 2006.

[47]The earlier period of credit scores for firms that obtained credit in the conventional lending market represents data D&B/FIC had readily available and could provide us. Appendix I contains details on the data used to perform this analysis.

Figure 6: Percentage of Small Business Credit Scores (2003-2006) for Firms That Received 7(a) and Conventional Credit in D&B/FIC Sample (1996-2000), by Credit Score Range



Source: GAO analysis of initial credit scores for loans in the SBA portfolio (2003-2006) and D&B/FIC's analysis of credit scores from data on small businesses in the small business portfolio score (SBPS) development sample (1996-2000).

Note: See app. I for details on the data used to perform this analysis.

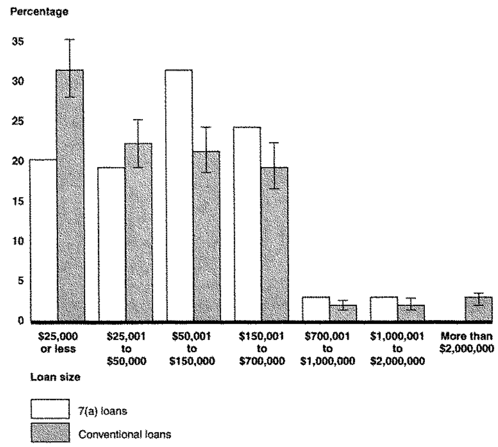
Another score developed by D&B, called the Financial Stress Score (FSS), gauges the likelihood that a firm will experience financial stress—for example, that it will go out of business.[48] SBA officials said that based on analyses of these scores, the difference in the repayment risk of lending associated with 7(a) loans was higher than the risk posed by small firms able to access credit in the conventional lending market. According to an analysis D&B performed based on these scores, 32 percent of 7(a) firms showed a moderate to high risk of ceasing operations with unpaid obligations in 2006, while only 17 percent of general small businesses had a similar risk profile.

[48]The FSS predicts the likelihood that a business will cease operations without paying creditors in full or go into receivership.

7(a) Loans Tended to Be Larger than Conventional Loans and to Have Variable Rates, Longer Maturities, and Higher Interest Rates

Compared with conventional loans, a greater percentage of 7(a) loans were for larger dollar amounts. For example, 61 percent of the number of 7(a) loans had dollar amounts in the range of more than $50,000 to $2 million (the maximum 7(a) loan amount), compared to an estimated 44 percent of the number of conventional loans (see fig. 7).[49] A larger share of conventional loans had dollar amounts of $50,000 or less—an estimated 53 percent, compared with 39 percent of 7(a) loans.

Figure 7: Percentage of 7(a) Loans and Conventional Loans by Loan Size, 2001-2004



Source GAO analysis of SBA and Federal Reserve Board of Governors' data

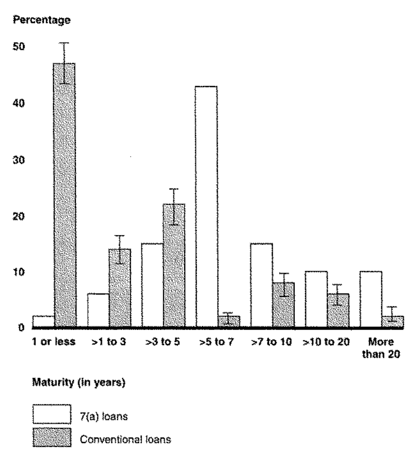
Note: The brackets on the conventional loans represent a 95 percent confidence interval. The maximum gross 7(a) loan amount is $2 million. The dollar range categories on this chart reflect program thresholds for loan amounts associated with different interest rates or guarantee fee levels.

Although more conventional than 7(a) loans were made for smaller amounts (i.e., less than $50,000), a higher proportion of conventional loan

[49]An estimated 3 percent of conventional loans had dollar amounts greater than $2 million.

dollars were concentrated in the highest loan amount category (i.e., more than $2 million). In contrast, 70 percent of loans with 7(a) guarantees were for amounts less than $150,000, while 78 percent of 7(a) loan dollars were concentrated in loans with amounts of $150,000 or greater. In addition, almost all 7(a) loans had variable interest rates and maturities that tended to exceed those for conventional loans. Nearly 90 percent of all 7(a) loans but only an estimated 43 percent of conventional loans had variable rates, and, almost 80 percent of 7(a) loans had maturities of more than 5 years, compared with 5 years or less for an estimated 83 percent of conventional loans (fig. 8).

Figure 8: Percentage of 7(a) and Conventional Loans by Loan Maturity Category, 2001-2004



Source: GAO analysis of SBA and Federal Reserve Board of Governors' data

Note: The brackets on the conventional loans represent a 95 percent confidence interval.

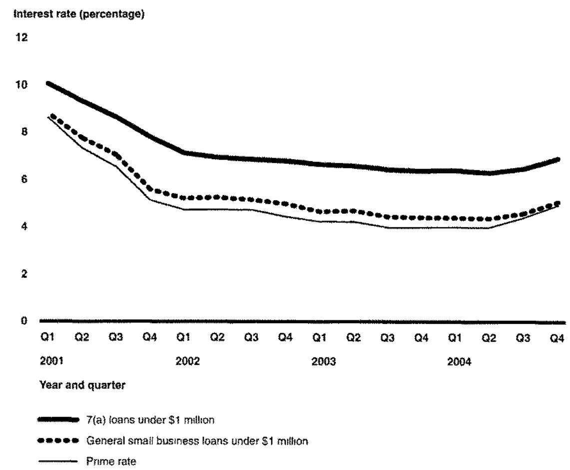
Finally, for loans under $1 million, interest rates were generally higher for 7(a) loans than for conventional loans. As shown in figure 9, from 2001 through 2004 quarterly interest rates for loans guaranteed by the 7(a) program were on average an estimated 1.8 percentage points higher than interest rates for conventional loans.[50] Interest rates for small business loans offered in the conventional market tracked the prime rate closely and were, on average, an estimated 0.4 percentage points higher.[51] Because the maximum interest rate allowed by the 7(a) program was the prime rate plus 2.25 percent or more, over the period, the quarterly interest rate for 7(a) loans on average exceeded the prime rate.[52]

[50]We used SBA data to calculate the calendar year and quarter in which each loan was approved and to calculate interest rates for all loans in a given quarter that were for under $1 million.

[51]We used the Federal Reserve's *Survey of Terms of Business Lending*, which provides information quarterly on commercial and industrial loans of loans in four size categories (less than $100,000; from $100,000 through $999,999; from $1 million through $999,999,000; and $10 million or more) made only by commercial banks. We used only data related to the first two categories because those loan amounts most resembled the 7(a) loans in the SBA data and, as discussed previously, SBA considers loans reported in call report data of $1 million or less to be for small businesses.

[52]We used the Federal Reserve's historical reports on the monthly bank prime rate to estimate the prime rate for every quarter from 2001 through 2004.

Figure 9: Interest Rates Comparison for Loans under $1 Million and Prime Rate, 2001-2004

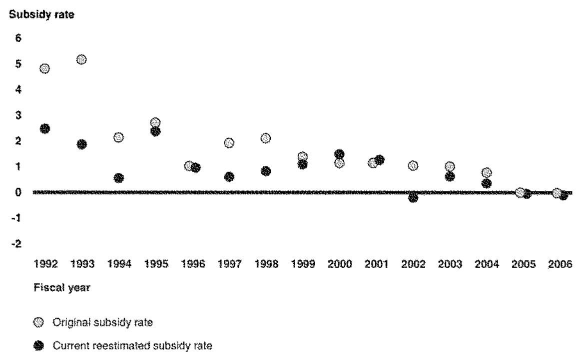


Source: GAO's analysis of SBA data, the Federal Reserve Board of Governors' quarterly *Survey of Terms of Bank Lending* (2001 to 2004), and the Federal Reserve Board of Governors' H.15 statistical release for bank prime loan rates.

Current Reestimates Show Lower-than-Expected Subsidy Costs, but Final Costs May be Higher or Lower for Several Reasons

SBA has predicted that the current reestimated credit subsidy costs of 7(a) loans made during fiscal years 1992 through 2004 generally will be lower than the original estimates (see fig. 10). Original estimates are made at least a year before any loan is made. The credit subsidy cost is often expressed as a percentage of loan amounts—that is, a credit subsidy rate of 1 percent indicates a subsidy cost of $1 for each $100 of loans. As figure 10 shows, the original credit subsidy cost estimated for fiscal years 2005 and 2006 was zero, since the 7(a) program became a "zero credit subsidy" program. Although the federal budget recognizes costs as loans are made and adjusts for these costs throughout the lives of the loans, the ultimate cost to taxpayers is certain only when none of the loans in a cohort remain outstanding and the agency makes a final, closing reestimate. For loans made in fiscal years 2005 and 2006, SBA adjusted the ongoing servicing fee it charges participating lenders so that the initial subsidy estimate would be zero based on expected loan performance at that time. In addition to the subsidy costs, SBA incurs administrative expenses for operating the loan guarantee program, though these costs are appropriated separately from the cost of the credit subsidy. In its fiscal year 2007 budget request, SBA requested nearly $80 million to cover administrative costs associated with the 7(a) program.

Figure 10: Original and Current Reestimated Credit Subsidy Rates for Loans Made from 1992 through 2006



Source 2008 Federal Credit Supplement

Any forecasts of the expected costs of a loan guarantee program such as 7(a) are subject to change, since the forecasts are unlikely to include all the changes in the factors that can influence the estimates. In part, the estimates are based on predictions about borrowers' behavior—how many borrowers will pay early or late or default on their loans and at what point in time. According to SBA officials, loan defaults are the factor that exerts the most influence on the 7(a) credit subsidy cost estimates and are themselves influenced by various economic factors, such as the prevailing interest rates. Since the 7(a) program primarily provides variable rate loans, changes in the prevailing interest rates would result in higher or lower loan payments, affecting borrowers' ability to pay and subsequently influencing default and prepayment rates. For example, if the prevailing interest rates fall, more firms could prepay their loans to take advantage of lower interest rates, resulting in fewer fees for SBA. Loan defaults could also be affected by changes in the national or a regional economy. Generally, as economic conditions worsen—for example, as unemployment rises—loan defaults increase. To the extent that SBA cannot anticipate these changes in the initial estimates, it would include them in the reestimates.

Beginning in fiscal year 2003, SBA has employed an econometric model that incorporates historical data and other economic assumptions for its credit subsidy cost estimates and reestimates instead of relying primarily on predictions based on historical average loan performance. In previous work we found that the econometric models SBA used to estimate defaults, prepayments, and recoveries were reasonable but that the agency could expand the type of data it used and its method of documenting its decisions regarding the models.[53] According to SBA officials, the agency has made some recent enhancements to the 7(a) credit subsidy cost model, including using more current financial data on borrowers participating in the 7(a) program. SBA officials explained that the agency had also begun validating loan data extracted for use in its econometric model by comparing these data to cohort- and program-level data from another SBA database containing summary loan data. Further, the model now better accounts for amounts SBA recovers from borrowers. SBA officials said that the annual review the agency conducts of the 7(a) credit subsidy cost model may result in minor future changes but that those changes would probably not have any significant impact on the subsidy estimates and reestimates.

Conclusions

According to the 7(a) loan program's underlying statutes and legislative history, 7(a) is intended to supplement, not compete with, the conventional lending market by helping address credit constraints that small businesses face. The 7(a) program's design is consistent with this intent—for example, the program's credit elsewhere requirement is designed to help ensure that loans made through the 7(a) program do not supplant credit already available in the conventional lending market. Reflecting the evolving mission of the program, 7(a)'s performance measures focus on the extent to which the program provides guaranteed loans to distinct groups of small businesses, such as start-ups and those

[53] GAO, *Small Business Administration: Model for 7(a) Program Subsidy Had Reasonable Equations, but Inadequate Documentation Hampered External Reviews*, GAO-04-9 (Washington, D.C.: Mar. 31, 2004).

whose owners face "special competitive opportunity gaps," including minority- or women-owned businesses. Our evaluation of the program's performance measures found that they were useful in showing how many loans had been made—that is the measures effectively show outputs, but that they did not provide adequate information on the extent to which SBA was meeting its strategic goal of helping small businesses succeed by identifying outcomes. As a result, the actual impact of the 7(a) program remains unclear.

Further, only limited evidence exists on the extent to which small businesses face credit constraints, such as credit rationing, in the conventional lending market. The studies we reviewed suggest that some small firms may face credit rationing within the conventional lending market, but these studies relied on older data. As a result, they did not account for recent trends in the conventional lending market, such as the use of credit scores, that could impact lending to small businesses by providing lenders with additional information to assess a small firm's risk. The effect that these developments may have on the credit constraints that some small businesses face is not yet known.

Based on our analysis, the 7(a) loan program appears to serve certain segments of the small business lending market in different proportions than conventional loans. A higher proportion of 7(a) loans went to minority-owned firms and start-ups, and these results are consistent with the program's legislative intent. But the shares of 7(a) and conventional loans that went to other segments of the small business lending market, such as women-owned businesses and those located in economically distressed areas, were more similar. These results may be useful to SBA as it considers how it administers the program, including its efforts to promote the 7(a) program to lenders and small businesses, and how it oversees participating lenders.

Beginning with fiscal year 2005, the 7(a) program's credit subsidy cost has been estimated at zero; however, the credit subsidy costs estimated for any fiscal year can change due to various factors and are not final until no loans from that year's cohort remain outstanding. Current credit subsidy reestimates of loans made in fiscal years prior to 2005 are lower than originally estimated. Nevertheless, changes in certain important factors, such as 7(a) loan defaults, can influence the 7(a) program's credit subsidy costs.

Recognizing its lack of outcome-based information on the firms that the 7(a) program assists, SBA has efforts underway to develop and implement performance measures to better track outcomes of the 7(a) program including how small firms fare after they participate in the 7(a) loan program. However, SBA has not made clear when, or even if, it plans to complete these efforts, in part because of the costs and legal concerns associated with obtaining the necessary information to undertake this impact analysis. Furthermore, since firms with SBA-guaranteed loans represent various geographic areas, go to both existing and new businesses, and have loan terms sensitive to prevailing economic conditions, many factors unrelated to the loans may impact how well firms do after receiving assistance. It is also unclear what benchmark for success SBA should adopt for these firms. But without some information on outcomes, SBA is unable to provide clear evidence about the impact its 7(a) program is having on firms it assists.

Firms able to meet their loan obligations signal that their businesses are continuing to operate in the communities they are located in and are, at a minimum, experiencing enough financial success to repay their loans. SBA already has loan performance data, such as the number of loans that are in default, prepaid, or in good standing, and other information on firms that receive assistance from the 7(a) program. These data may be reasonable proxies for how well firms are faring after receiving guaranteed loans. In addition, although SBA could incur costs for collecting additional outcome-based information, data reflecting the success of assisted businesses—such as the number that go out of business or begin to rely on conventional credit—could be useful performance measures.

Recommendation for Executive Action

To better ensure that the 7(a) program is meeting its mission responsibility of helping small firms succeed through guaranteed loans, we recommend that the SBA Administrator complete and expand SBA's current work on evaluating the program's performance measures. As part of this effort, at a minimum SBA should further utilize the loan performance information it already collects, including but not limited to defaults, prepayments, and number of loans in good standing, to better report how small businesses fare after they participate in the 7(a) program.

Agency Comments and Our Evaluation

We provided SBA with a draft of this report for review and comment. SBA provided comments in a letter from the Deputy Associate Administrator of SBA's Office of Capital Access. The letter is reprinted in appendix IV. SBA agreed with our recommendation but disagreed with a comparison in the section of our report on credit scores, one of a number of comparisons included in our analysis of the segments of the small business lending market that are served by 7(a) and conventional loans.

Specifically, to assess the relative creditworthiness of firms receiving 7(a) loans to firms receiving conventional credit, we compared the initial credit scores for loans in SBA's 7(a) portfolio to scores for conventional loans calculated from a database developed by D&B/FIC. Our analysis of this information showed only limited differences in the credit scores of borrowers with 7(a) and conventional loans. Our draft and final report also disclosed that the results of this analysis should be interpreted with some caution because the time periods of the two sets of credit scores are different and the credit scores for small businesses with conventional loans may not be representative of the population of small businesses. In its written comments, SBA primarily reiterated the cautions included in our report and stated that it disagreed with the results of our analysis showing limited differences in the credit scores of borrowers with 7(a) and conventional loans. SBA stated that the riskiness of a portfolio is determined by the distribution in the riskier credit score categories. Although stating that "the numbers have not been worked out," SBA concluded that the impact on loan defaults from the higher share of 7(a) loans in these categories would not be insignificant.

The intent of our analyses of credit scores and other borrower and loan characteristics is to provide a comparison of the segments of the small business lending market that are served by 7(a) and conventional loans, and our analyses are not intended to quantify the impact of differences in these characteristics on 7(a) defaults. We continue to believe that our analysis of credit scores provides a reasonable basis for comparing the share of businesses in different credit score categories. Specifically, the data we used were derived from a very large sample of financial transactions and consumer credit data and reflect the broadest and most recent information readily available to us on small business credit scores in the conventional lending market. Recognizing the limitations associated with these data, in the future analyzing more comparable data on credit scores for small business borrowers with conventional loans may provide SBA and others with a more conclusive picture of the relative riskiness of borrowers with 7(a) and conventional loans. Such an analysis would be consistent with our recommendation.

In addition, SBA provided technical comments, which we incorporated into the report as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to other interested congressional committees and the Administrator of the Small Business Administration. We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

Sincerely yours,

William B. Shear

William B. Shear
Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope and Methodology

In this report, we examined (1) the statutory framework and legislative history of the 7(a) program and performance measures the Small Business Administration (SBA) utilizes to assess program results; (2) factors in the conventional lending market that may affect small businesses' access to credit, including market imperfections; (3) how the segments of the small business lending market served by 7(a) loans compare with segments served by conventional loans; and (4) differences in SBA's estimates and reestimates of 7(a)'s credit subsidy costs and the factors that may cause uncertainty about the costs of the 7(a) program to the federal government.

Analysis of Statutory Framework of 7(a) Program and Its Performance Measures

To describe the purpose of the 7(a) program, we reviewed the program's underlying statutes and legislative history to understand how the program was intended to help small businesses. To assess SBA's performance measures for the 7(a) program, we selected performance measures specific to the 7(a) program as reported in the SBA's recent Performance and Accountability Reports. We evaluated nine different performance measures against six attributes identified in our earlier work as being indicative of successful performance measures.

Taken from SBA's fiscal year 2006 Performance and Accountability Report, the nine performance measures were:

1. number of new loans approved to start-up small businesses,
2. number of new loans funded to start-up small businesses,
3. number of start-up small businesses assisted,
4. number of new loans approved to existing small businesses,
5. number of new loans funded to existing small businesses,
6. number of existing small businesses assisted,
7. number of new loans approved to small businesses facing special competitive opportunity gaps,
8. number of new loans funded to small businesses facing special competitive opportunity gaps, and
9. number of small businesses facing special competitive opportunity gaps assisted.

Taken from our earlier report, *Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures* (GAO-03-143), the six attributes we assessed the above mentioned performance measures against were:

1. core program activity (measures cover the activities that an entity is expected to perform to support the intent of the program),

2. measurable target (measure has a numerical goal),
3. reliability (measure produces the same result under similar conditions),
4. clarity (measure is clearly stated and the name and definition are consistent with the methodology used to calculate it),
5. objectivity (measure is reasonably free from significant bias or manipulation), and
6. linkage (measure is aligned with division and agencywide goals and mission).

We reviewed and summarized agency documents relating to its ongoing contract with the Urban Institute regarding evaluative studies of SBA's lending programs, including the 7(a) program, currently underway. We also interviewed SBA officials to understand agency efforts to improve its 7(a) program performance measures.

Economic Literature on Credit Rationing and Discrimination

To identify constraints that may limit credit to small businesses we summarized published, peer-reviewed articles that discuss the subject of credit rationing with regard to firms. We identified articles through reviews of citations of the most recent literature, and by identifying current papers that cite the influential papers in this field (e.g., Stiglitz and Weiss (1981)), and by using article search engines, such as "google scholar" and "jstor." The review concentrated on empirical studies of the U.S. financial market, although studies of the non-U.S. market were included in order to understand the various empirical methodologies employed in this area. In addition, we summarized recent peer-reviewed studies that explore the extent of racial, ethnic, and gender disparities within the conventional lending market. Studies published by think tanks and others that were not peer-reviewed were not included in our review. Appendix II includes a more detailed description of the studies we reviewed about credit rationing and discrimination.

Comparison between 7(a) and Conventional Loans

As described more fully in the following sections, to assess similarities and differences in the small business lending market segments served by 7(a) and conventional loans, we compared relevant information on loan terms and borrower characteristics using several data sources. Our analysis was restricted to loans made to firms located within the 50 states, and did not include Puerto Rico or any U.S. territories. To assess the reliability of the data used, we reviewed applicable documentation associated with the specific data source, such as a data dictionary, survey questionnaire, and methodology report. We interviewed officials at the Board of Governors of the Federal Reserve System (Federal Reserve) and SBA who provided us the data in order to understand any data limitations and how the data are collected and stored. We also consulted with Dun & Bradstreet Corporation and Fair Isaac Corporation (D&B/FIC) officials about their data used to generate credit scores for small businesses, including those used by the SBA. Finally, we conducted logic and electronic tests of each data source. We determined the data to be sufficiently reliable for use in our report.

Number of Loans and Loan Dollars Outstanding

To compare the number and amount of outstanding small business loans to 7(a) loans, we used the Federal Deposit Insurance Corporation's (FDIC) Consolidated Reports of Condition and Income (call reports) for U.S. banks. U.S. commercial banks and insured savings institutions are required by federal law to report certain financial information to their appropriate bank regulator quarterly, which FDIC then consolidates and maintains in a database. For the purposes of the call reports, a small business loan is defined by SBA's Office of Advocacy as a commercial and industrial loan or a non-farm, nonresidential loan for which the original amount was $1 million or less. Therefore, we considered the call report data on loans under $1 million to be a proxy for general small business loans, even though there is no attempt to directly link the loans to the size of the firm accessing credit in the call report data. SBA reports tabulations of call report data prepared for the agency by an external contractor as of June 2005, the latest data available. We requested that SBA provide us with similar information on the number and amount of outstanding 7(a) loans under $1 million as of September 30, 2005.

Loan and Borrower Characteristics

To evaluate SBA's 7(a) borrowers and loan terms, we used data from two SBA administrative data systems: (1) the Loan Accounting System and (2) the Loan/Lender Monitoring System for information to describe 7(a) loans and borrowers. To assess general small business borrowers and loan terms, we used the 2003 Survey of Small Business Finances (SSBF) conducted by the Federal Reserve. We also used Federal Reserve's historical reports on the monthly bank prime rate in its *Survey of Terms of Bank Lending* to report the quarterly interest rates for loans under $1 million. In addition, we obtained from the D&B/FIC small business credit scores derived from their Small Business Predictive Score development sample.

SBA's data include various information describing the loan, such as the percentage of the loan guaranteed by SBA, the number of months to maturity, and whether the loan had a fixed or variable interest rate. The data also include information on the small firm, such as the ethnicity and gender of the principal owner, the number of employees, and the firm's status as new (i.e., less than 2 years old). SBA provided us with 304,032 records from its administrative data systems, which contained information on all loans approved and disbursed in calendar years 2001 through 2005. Based on discussions with SBA officials about the data and logic testing, we eliminated certain cases from the data provided that had missing values, zero values where appropriate, or that SBA officials confirmed as incorrect data. We eliminated records with any missing or confirmed incorrect information in order to have the same number of cases for each analysis performed. This reduced the number of 7(a) records by 7,495.[1] SBA officials identified an additional 1,730 incorrect social security numbers, which further reduced the number of 7(a) records. We also eliminated 24,010 records to delete multiple loans to the same business. In order to make the SBA data more comparable to the SSBF data, we included only SBA loans a borrower received between 2001 and 2004, which further reduced the number of 7(a) records by 78,056. The final number of 7(a) records we used in our analysis was 192,741, representing a 36 percent decrease in the number of records originally provided by SBA.

We used information from the SSBF as a proxy for loans made to small firms within the conventional lending market (i.e., not made with the assistance of the 7(a) program).[2] The SSBF interviewed 4,240 firms in 2004 and early 2005 that were selected to provide a representative sample of all small businesses in the United States.[3] Among other things, the SSBF assesses credit availability for small businesses, provides financial data for

[1]For example, we eliminated records where a loan maturity date preceded or equaled the disbursement date or records in which the SBA-guaranteed percentage exceeded the maximum level allowed by the program.

[2]According to *Financial Services Used by Small Businesses: Evidence From the 2003 Survey of Small Business Finances*, about 1 percent of small businesses indicated that the government was the supplier of their financial services. Federal Reserve staff noted that this percentage may understate the incidence of 7(a) loans because, among other reasons, some respondents may have been unaware that they received an SBA-guaranteed loan.

[3]The SSBF initially selected 37,600 firms from D&B's Dun's Market Identifier file, of which 9,687 passed to the main questionnaire stage, and 4,268 firms completed their interviews, resulting in a weighted overall response rate of 32.4 percent. These firms represent 6.3 million small businesses. Firms eligible for the SSBF include for-profit, nonagricultural, nondepository institutions, nongovernment businesses in operation in December 2003 and during the interview, that also had less than 500 employees.

small businesses currently unavailable from other sources, and validates geographic and product market definitions. SSBF data are used to study the effects of changes within the lending industry on credit use by small businesses and to monitor technological and competitive changes in markets for financial services used by small businesses. We used records in which firms reported that the last loan they had applied for had been approved. Applying this standard reduced the number of records by 2,479. We further eliminated records in which firms reported obtaining their most recent loan outside of 2001 to 2004 and firms reporting zero employees, which further decreased the number of records by 23. The final unweighted number of records from the SSBF data was 1,738. Since the data were from a sample with statistical weights, all the percentages in the body of the report reflect weighted percentages. In addition, the SSBF includes multiple imputed values. Our standard error and confidence interval calculations incorporate the multiple imputations where appropriate. We calculated the standard error and confidence intervals for each of the analyses performed using these data since they are based on a random sample. Unless otherwise noted, all percentage estimates have a 95 percent confidence interval within plus or minus 5 percentage points.

The following are more detailed descriptions of actions we took to make the data from SBA and SSBF more comparable:

Minority Status of Ownership

SBA's data include an indicator for whether more than 50 percent of the small business owners are from racial or ethnic minority categories. For the first time, the 2003 SSBF combined data on up to three owners and calculated various indicators by majority owner share. The SSBF data included two data fields related to race and ethnicity that we used. The first field designated whether more than 50 percent of the ownership was white, and the second field designated whether 50 percent or more of the ownership was minority or Hispanic. Using these fields, we compared the share of 7(a) and conventional loans that went to small businesses with 50 percent or greater minority ownership.

Longevity of Business

SBA's data include information indicating whether or not the business was new, which SBA defines as being less than 2 years old. The SSBF's information included information on the year of the survey and the year when the firm applied for its most recently approved loan. In addition, the survey included an age for the firm. We calculated the age of the firm when it applied for the most recent loan. We considered a business as new if its age was 2 years or less when it applied for its most recently approved loan.

Number of Employees

The number of employees in SBA's data is the number provided by the prospective borrower at the time of loan approval. According to SBA, the number of employees is required as part of the application process, so any zeros in this field should be treated as missing values. Additionally, we eliminated SBA records that listed the number of employees as 500 or greater to match the SSBF's selection criteria. The SSBF's data included information on the number of full- and part-time employees. All cases specifying zero employees were eliminated.

Gender of Ownership

Both SBA's data and the SSBF's data had information designating whether more than 50 percent, less than 50 percent, or exactly 50 percent of the firm was female-owned. We compared the groups of more than 50 percent female ownership, exactly 50 percent female/male ownership, and more than 50 percent male ownership receiving 7(a) and conventional loans.

Economically Distressed Areas

We created a variable indicating whether or not a given geographic location in which a business receiving a loan is situated, is in economic distress. The indicator we chose was based on the minimum eligibility criteria for the Empowerment Zone and Enterprise Community (EZ/EC) and the Renewal Community (RC) programs, which target federal grant monies to public and private entities, tax benefits to businesses, or both in order to improve conditions in competitively selected, economically distressed communities. The minimum poverty level eligibility requirement for EZ/EC and RC is that at least 20 percent of the population in the census tracts that make up the zone must have incomes below the national poverty line. Using data from the 2000 Census, we used the Census Zip Code Tabulation Areas (which approximate zip code boundaries) to identify zip codes in which 20 percent or more of the individuals had income below the poverty level. We matched the zip codes of businesses receiving 7(a) loans from 2001 through 2004 (using updated geography to account for changes to zip code boundaries) to the 2000 Census file to quantify how many 7(a) loans went to businesses in economically distressed areas. The business locations for respondents to the SSBF are not included in the public use data file. However, Federal Reserve staff matched our distress indicator to the zip codes for their respondents and returned the data to us for merging with the public file without revealing respondents' business locations. We then compared the shares of 7(a) and conventional loans that went to economically distressed areas.

Business Organization

SBA's data included three organizational types—individual (or sole proprietorship), partnership, and corporation. The SSBF included nine organization types—sole proprietorship, partnership, S corporation, C corporation, limited liability partnerships tax filed as partnerships or corporations, and limited liability corporations tax filed as sole proprietorships, partnerships, or corporations. We combined the two types of sole proprietorships, the three types of partnerships, and the four types of corporations in the SSBF's data to provide comparable information.

Geographic Information

The only geographic information in the SSBF's data was the census region in which the firm was located.[4] The state listed in SBA's data was used to group the 7(a) data according to census regions.

Interest Rates

In order to compare interest rates on 7(a) loans to loans general small businesses obtained in the conventional lending market, we used data from the Federal Reserve's *Survey of Terms of Bank Lending*. The survey provides information quarterly on the number of commercial and industrial loans by four size categories (less than $100,000; between $100,000 and $999,999; between $1 million and $999,999,000; and $10 million or more) made only by commercial banks.[5] The survey reports an average interest rate in each category that is weighted by loan amount. We only used data related to the first two categories because those loan amounts most resembled the 7(a) loans in the SBA data and because SBA's Office of Advocacy considers in call report data, discussed previously, loans of $1 million or less to be for small businesses. Limitations to these data regarding our analysis include that the information is gathered during 1 week in the middle month of each quarter and does not distinguish between the sizes of the business obtaining the loan.[6] In addition, the data in the survey do not include loans made by finance companies or small

[4]The Bureau of Census organizes the 50 states and District of Columbia into nine regions, as follows: (1) East North Central (Ohio, Indiana, Illinois, Michigan, and Wisconsin); (2) East South Central (Kentucky, Tennessee, Alabama, and Mississippi); (3) Middle Atlantic (New York, New Jersey, and Pennsylvania) (4) Mountain (Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah, and Nevada); (5) New England (Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut); (6) Pacific (Washington, Oregon, California, Alaska, and Hawaii); (7) South Atlantic (Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, and Florida); (8) West North Central (Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, and Kansas); and (9) West South Central (Arkansas, Louisiana, Oklahoma, and Texas).

[5]The survey does not include information on loans under $1,000.

[6]Gross loan extensions made during the first full business week in the middle month of each quarter by a sample of 348 commercial banks of all sizes. The sample data are used to estimate the terms of loans extended during that week at all insured commercial banks. The survey notes that the estimated terms of bank lending are not intended for use in measuring the terms of loans extended over the entire quarter or residing in the portfolios of those banks.

business loans made on credit cards. In order to compare interest rate data we derived from the survey, we used SBA data to calculate the calendar year and quarter in which each loan was disbursed and calculated the average interest rates for all loans disbursed in a given quarter that were for under $1 million. In order to be consistent with the survey, we calculated the average quarterly interest rate using the loan amounts as weights. Finally, we used Federal Reserve's historical reports on the monthly bank prime rate to estimate the prime rate for every quarter from 2001 through 2004.

Credit Scores

To assess the relative creditworthiness of firms receiving 7(a) loans to firms receiving conventional credit, we compared the initial credit scores for loans in SBA's 7(a) portfolio to scores calculated from D&B/FIC's large sample of data from small businesses in the conventional lending market and from consumer credit bureaus. In comparing credit scores for 7(a) firms with other firms, we relied on D&B/FIC's analysis of credit scores based on data from small business transactions, consumer credit bureaus, and loan performance from their user's lending portfolios from 1996 through 2000, known as the Small Business Predictive Score (SBPS) development sample. The loans D&B/FIC used for its sample were outstanding loans including those that originated between 1996 and 2000 and older loans. We relied on the D&B/FIC data from a different time period because time and resource constraints prohibited obtaining more recent data. As stated previously, our comparison of credit scores should be interpreted with caution because the data come from different time periods and the D&B/FIC credit scores may not be representative of the population of general small businesses. However, although the data D&B/FIC used to develop its small business credit score may not be statistically representative of all small businesses, the data sample is very large and reflects the broadest and most recent information readily available to us on small business credit scores in the conventional lending market.

Description of Credit Subsidy Cost Estimates and Reestimates

To describe 7(a)'s credit subsidy cost estimates and reestimates we compared SBA's original credit subsidy cost estimates for fiscal years 1992 through 2006 to SBA's reestimates in fiscal year 2008, as reported in the fiscal year 2008 Federal Credit Supplement. We reviewed documents related to the 7(a) credit subsidy cost model, which the agency uses to generate its estimates and reestimates. We also interviewed SBA officials to understand any differences in the reported original credit subsidy cost estimates and subsequent reestimates, as well as to describe what factors may influence future reestimates.

Analysis of 504 Loan Program

We were unable to undertake a similar comparative analysis between 504 loans and loans made to general small businesses within the conventional lending market primarily due to the limited number of observations of conventional loans that were comparable to loans with 504 guarantees and lack of generalizability with the SSBF data. We have included in appendix III information on the characteristics of borrowers and loans financed under SBA's 504 program based on analysis done using data provided by SBA. We performed the same eliminations of observations for missing or incorrect data that we applied to the 7(a) data as described above, which resulted in a 28 percent (from 28,341 to 20,289) decrease in the number of cases used in our analysis.

We performed our work in Washington, D.C., and Chicago from May 2006 through July 2007 in accordance with generally accepted government auditing standards.

Appendix II: Summary of Economic Literature on the Empirical Evidence for Credit Rationing and Discrimination in the Conventional Lending Market

Study	Objective	Data	Method	Conclusions and limitations
Berger, Allen N., and Gregory F. Udell, "Some Evidence on the Empirical Significance of Credit Rationing," *The Journal of Political Economy*, vol. 100, no. 5 (1992): 1047–1077.	One implication of credit rationing is that commercial loan rates do not respond quickly to changes in the market interest rate—i.e., are sticky. Objective was to develop and implement a series of empirical tests able to determine whether loan rate stickiness is explained by credit rationing or something else.	Contract information from 1977 through 1988 on approximately 1 million bank loan contracts.	Tested for "stickiness" and whether it is mitigated by specific loan contract features, such as commitment or collateral. Because commitment loans act as insurance against rationing, they can be used as a test for whether stickiness stems from credit rationing. Because rationing is more likely when open market interest rates are high, also examines the proportion of loans that are made in commitment agreement and whether it increases with the interest rate.	Found evidence inconsistent with credit rationing. Could not conclude that stickiness stems from credit rationing, since nearly half of the loan rate stickiness occurs with commitment loans. The proportion of loans that were commitment loans decreased during credit market tightness, the direction opposite from that predicted by credit rationing. Concluded that these results did not disprove the existence of credit rationing of commercial bank borrowers but indicated that rationing does not constitute an important macroeconomic phenomenon.

Study	Objective	Data	Method	Conclusions and limitations
Berger, Allen N., and Gregory F. Udell, "Relationship Lending and Lines of Credit in Small Firm Finance," *The Journal of Business*, vol. 68, no. 3 (1995): 351–381.	To examine the effect of relationship lending in small firm finance. Hypothesized that banks may acquire private information over the course of a relationship; therefore, focused on lines of credit issued to small business.	1988-89 National Survey of Small Business Finances survey of 3,404 businesses.	Assessed the empirical relationship between relationship lending and collateral. Focused exclusively on lines of credit, using the firm's age and the number of years it had done business with the lender as measures of how information can change the terms of credit.	Found evidence consistent with credit rationing. Highlighted the role of relationship lending in loan contracts and provided support for credit rationing. The evidence indicated that small firms with longer relationships pay lower interest rates and are also less likely to pledge collateral. Results suggested that banks accumulate increasing amounts of private information over the duration of the bank-borrower relationship and use the information when defining contract terms. Found that results were consistent with theoretical arguments that relationship lending generates valuable information about borrower quality, which is consistent with credit rationing.
Berkowitz, Jeremy, and Michelle J. White, "Bankruptcy and Small Firms' Access to Credit," *The RAND Journal of Economics*, vol. 35, no.1 (2004): 69–84.	To examine how personal bankruptcy law affects small firm access to credit by exploiting state variation in assets shielded from bankruptcy proceedings. Because many small business loans are secured with personal credit, hypothesized that firms in high-exemption states are more likely to be denied credit or be credit rationed.	1993 National Survey of Small Business Finances survey of 5,356 small businesses operating as of year-end 1992.	Tested for credit rationing by exploiting state variation in the type and amount of assets shielded from bankruptcy proceedings. This follows from the study's model, derived from economic theory, which suggests that the more assets shielded from bankruptcy, the greater the incentive to declare bankruptcy.	Found evidence of credit rationing but under a broader definition than other studies. According to the study's definition, managers who are denied credit or discouraged from applying have been "credit rationed." Concluded that higher personal exemptions increase credit rationing. Firms are more likely to be denied credit and, if offered credit, at higher interest rates.

Study	Objective	Data	Method	Conclusions and limitations
Blanchflower, David G., Philip B. Levine, and David J. Zimmerman, "Discrimination in the Small-Business Credit Market," *The Review of Economics and Statistics*, vol. 85, no. 4 (2003): 930–943.	To examine the presence of discrimination in the small business credit market.	1993 and 1998 editions of the National Survey of Small Business Finances.	Using a regression approach, tested whether differences in rates of loan denial or interest by demographic group can be explained by differences in credit worthiness or other factors, including credit scores.	Found mixed results with respect to discrimination. Using a large amount of controls, found significant evidence that African American-owned firms face obstacles in obtaining credit, with lower application rates and higher denial rates. Also found that African American-owned firms were charged higher interest rates. The study referred to the magnitude of the difference for African Americans as substantial but could not find evidence of similar discrimination against women or other ethnic groups.
Bodt, Eric de, Frederic Lobez, and Jean-Christophe Statnik, "Credit Rationing, Customer Relationship, and the Number of Banks: An Empirical Analysis," *European Financial Management*, vol. 11, no. 2 (2005): 195–228.	To estimate the effect of bank mergers on access to credit.	Data from a questionnaire sent to 4,932 Belgian firms that met certain selection criteria on data quality and being a small business.	Analyzed the relationship between the numbers of banks used by the firm, customer relationship, and credit rationing for these businesses.	Found no general rule that related the number of banks a firm does business with to the extent of credit rationing. For example, found that smaller firms dealing with big main banks should increase the number of banks in order to minimize the probability of being rationed. Larger firms, dealing with local banks, in contrast, should concentrate financing to limit rationing.
Cavalluzzo, Ken S., and Linda C. Cavalluzzo, "Market Structure and Discrimination: The Case of Small Business," *Journal of Money, Credit and Banking*, vol. 30, no. 4 (1998): 771-792.	To estimate the prevalence of prejudicial discrimination in small business lending.	1988-89 National Survey of Small Business Finances survey of 3,404 businesses, including information on applications for credit and their outcome.	Using the insight that the more competitive a market is, the less the likelihood is of prejudicial discrimination, the study regressed interest rates, rates of application, and denial of credit on measures of concentration of the banking industry where loans were made.	Evidence on discrimination was mixed. Found evidence of prejudicial discrimination against Hispanics and Asians. Found that African American-owned small businesses hold fewer loans but did not find that this stemmed from prejudicial treatment. Found that prejudicial discrimination may favor women.

Study	Objective	Data	Method	Conclusions and limitations
Cavalluzzo, Ken S., Linda C. Cavalluzzo, and John D. Wolken, "Competition, Small Business Financing, and Discrimination: Evidence from a New Survey," *Journal of Business*, vol. 75, no. 4 (2002): 641–679.	To examine whether differences in interest rates, rates of denial, and application rates by gender and race can be linked to discrimination.	1993 National Survey of Small Business Finances survey of 5,356 small businesses operating as of year-end 1992.	Using a regression, used bank concentration to identify prejudicial discrimination. Examined loan application, denial, and interest rates, as well as firms discouraged from applying for credit. Used a rich set of control variables, such as whether borrowers had experienced bankruptcy and the borrowers' credit scores.	Found evidence of discrimination in the small business lending market. Found some evidence of prejudicial discrimination against African Americans and more robust evidence of prejudicial discrimination against women.
Cole, Rebel A., "The Importance of Relationships to the Availability of Credit," *Journal of Banking and Finance*, vol. 22 (1998): 959–977.	To examine the effect of preexisting relationships between lenders and firms on credit availability.	1993 National Survey of Small Business Finances survey of 5,356 small businesses operating as of year-end 1992.	Estimated the effect of relationships on credit availability. Used other types of bank services the firms used, as well as length of relationships, as measures of the strength of the relationship. Whether a firm was extended credit was a measure of credit availability.	Provided evidence consistent with credit rationing, concluding that a preexisting relationship between firm and lender increases the chances that credit will be extended but that the length of the relationship is unimportant.
Cowling, Marc, and Peter Mitchell, "Is the Small Firms Loan Guarantee Scheme Hazardous for Banks or Helpful to Small Business?" *Small Business Economics*, vol. 21, no. 1 (2003): 63–71.	To test an underpinning of credit rationing—that the rate of default increases with the cost of capital—i.e., the interest rate.	Data on 42,316 loans issued with collateral provided by the U.K. Small Firm Loan Guarantee Scheme.	Presented two alternative tests. First, estimated the effect of firm and loan level characteristics on default, and second tested for the effect of factors that change over time.	Found that consistent with credit rationing, default rate increases with the interest rate. However, also found that a series of other factors not addressed by the credit rationing literature, such as the loan's purpose, also affect default rate.

Study	Objective	Data	Method	Conclusions and limitations
Cressy, Robert, "Are Business Startups Debt-Rationed?" *The Economic Journal*, vol. 106 (1996): 1253–1270.	If financial capital affects business survival, this is evidence that credit constraints exist for some businesses. Objective was to examine whether human capital (such as education) might be an alternative explanation. If human capital is correlated with access to credit, then previous studies that failed to correct for this might incorrectly associate financial assets with business survival.	A sample of 2,000 U.K. start-ups that opened business accounts in 1988.	Tested for debt rationing after correcting for human capital. Used several measures for human capital—proprietors' age, education, work experience in the area of the start-up.	Found no evidence for debt rationing. Evidence suggested that human capital is the true determinant of survival and that the importance of financial capital is spurious. Firms with more human capital are more likely to accept a bank's offer. Concluded that, rather than a bank's selecting firms, they self-select for finance and those firms with more human capital are more likely to accept the bank's offer.
Holtz-Eakin, Douglas, David Joulfaian, and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *The Journal of Political Economy*, vol. 102, no. 1 (1994): 53–75.	To examine why some individuals survive as entrepreneurs and some do not. Focused on the role of access to capital. Tested an implication of credit rationing—that individuals will face liquidity constraints.	1981 and 1985 federal tax return data on individuals who received inheritances.	Tested whether an inheritance affects business survival. One implication of liquidity constraints would be that entrepreneurs who have access to financial resources independent of the credit market, such as inheritances, are more likely to succeed.	Although not on the subject of small business lending, provided support for credit rationing. Results suggested that a sizable inheritance has a small but noticeable effect on business survival and a larger effect on business receipts, which is consistent with an implication of credit rationing and liquidity constraints.

Study	Objective	Data	Method	Conclusions and limitations
Levenson, Alec R., and Kristen L Willard, "Do Firms Get the Financing They Want? Measuring Credit Rationing Experienced by Small Businesses in the U.S." *Small Business Economics*, vol. 14, no. 2 (2000): 83–94.	To measure the extent to which small businesses in the late 1980s were able to access external credit at a level they desired. The extent to which this is not true forms the upper bound of credit rationing, since some firms denied credit are actually credit unworthy.	1988-89 National Survey of Small Business Finances survey of 3,404 businesses.	To find an upper bound for the existence of credit rationing, estimated the percentage of small businesses denied credit. Included in the analysis firms denied credit and firms discouraged from applying for credit.	Found evidence consistent with credit rationing. Estimated that an upper bound of 6.36% of firms was rationed. The firms that were rationed represented 3.22% and 3.46% of sales and employment in the survey. Consistent with expectations, credit rationing was associated with firm size. While finding evidence consistent with credit rationing, the evidence suggested that equilibrium credit rationing is economically unimportant for the small firms analyzed.
Perez, Stephen J., "Testing for Credit Rationing: An Application of Disequilibrium Econometrics," *Journal of Macroeconomics*, vol. 20, no. 4 (1998): 721–739.	To test whether firms experience credit rationing by testing for excess demand. If there is no credit rationing, then the market will be at equilibrium and the supply of credit will equal demand.	5,000 firm-year observations from the CompuStat database of publicly traded firms for each year from 1981 through 1991.	Developed a model that allowed an empirical test for credit rationing. To implement the model, used maximum likelihood methods to test three samples of the population: firms with assets less than $10 million, assets $10 million to $25 million, and assets $25 million to $50 million.	Concluded that credit rationing exists. In all three samples, concluded that some firms face excess demand and are credit rationed while some do not. Found that the mean probability that the smallest firms are rationed was 61.9%, medium firms 59.1%, largest firms 59.8%. This suggested that smaller firms are more likely to be credit rationed. Did not test for whether the differences were statistically significant.

Study	Objective	Data	Method	Conclusions and limitations
Petersen, Mitchel A., and Raghuram G. Rajan, "The Benefits of Lending Relationships: Evidence from Small Business Data," *The Journal of Finance*, vol. 49, no. 1 (1994): 3–37.	To test whether ties between a firm and its creditor affect the cost and availability of credit to the firm and whether they mitigate the effect of credit rationing. Argued that "adverse selection and moral hazard may have a sizeable effect when firms are young and small," which made the sample likely to show the effects of credit rationing.	1988-89 National Survey of Small Business Finances survey of 3,404 businesses.	Estimated the effect relationships have on credit availability and interest rates. Using a regression, tested for the significance of a variety of relationship measures, such as relationship length in years, use of other financial services at the bank, and number of other banks the firm borrows from.	Presented evidence consistent with credit rationing. For interest rates, found a small effect of concentrating business with a single bank on the price charged by lenders; found that firms that borrowed from multiple banks had increased interest rates; and that there was little effect on the length of the relationship. On credit availability, found stronger effects of relationships: the availability of credit from institutions increases as the firm spends more time in the financial relationship and increases the number of financial services used, as that concentrates borrowing at that bank. Argued that these results are consistent with credit rationing but might also be consistent with a reduction in lender's expected cost.
Sofianos, George, Paul Wachtel, and Arie Melnik, "Loan Commitments and Monetary Policy," *Journal of Banking and Finance*, vol. 14 (1990): 677–689.	To measure the effect of loan commitments on how monetary policy affects the economy. Commitment is an agreement between the bank and the firm to lend an amount but not at a fixed interest rate. Consequently, a loan commitment should, in the short run, prevent a firm from being credit rationed.	A 1973–87 monthly survey of commercial banks conducted by the Board of Governors of the Federal Reserve.	Examined whether loans under commitment are less affected by a period of monetary tightening, since the bank cannot choose to refuse credit.	Presented evidence consistent with credit rationing. While both types of loans are affected by interest rates, found evidence of a differential effect of monetary policy on loans under commitment. Concluded that quantity rationing occurs in the market for bank loans. Also concluded that borrowers' willingness to obtain commitment loans, at an expense, is consistent with the desire to insure against credit rationing.

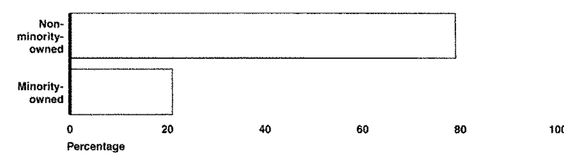
Study	Objective	Data	Method	Conclusions and limitations
Trovato, Giovanni, and Marco Alfo, "Credit Rationing and the Financial Structure of Italian Small and Medium Enterprises," *Journal of Applied Economics*, vol. 9, no. 1 (2006): 167–184.	To analyze the effect of credit subsidies on the development of small and medium Italian enterprises.	Survey data from 1989 through 1994 of approximately 1,919 Italian firms.	Tested whether firms that gain subsidies are more likely to reduce their financial constraints and increase investment levels.	Presented evidence consistent with credit rationing. Found that firms' leverage is positively related to the presence of public subsidies.

Source: GAO analysis.

Appendix III: Descriptive Statistics of 504 Loan Program

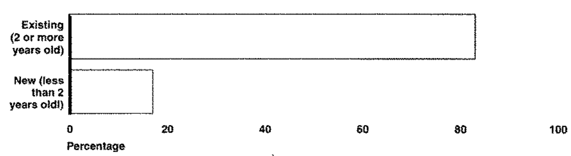
As stated previously, 504 loans generally provide long-term, fixed-rate financing to small businesses for major fixed assets, such as land and buildings. The following figures provide descriptive statistics for 504 loans approved and disbursed from 2001 through 2004, including information on the characteristics of 504 loans and borrowers. Not all information available for the 7(a) loans described in the body of the report was available for the 504 loans. For example, SBA does not collect interest rate data for 504 loans. Additionally, because 504 loans are only offered with set maturities (mostly 10 or 20 year) and fixed interest rates, there are no data on revolving loans or loans with variable interest rates.

Figure 11: Percentage of 504 Loans by Minority Status of Ownership, 2001-2004



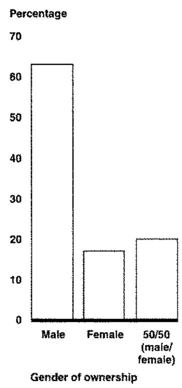
Source GAO analysis of SBA data

Figure 12: Percentage of 504 Loans by Status as a New Business, 2001-2004



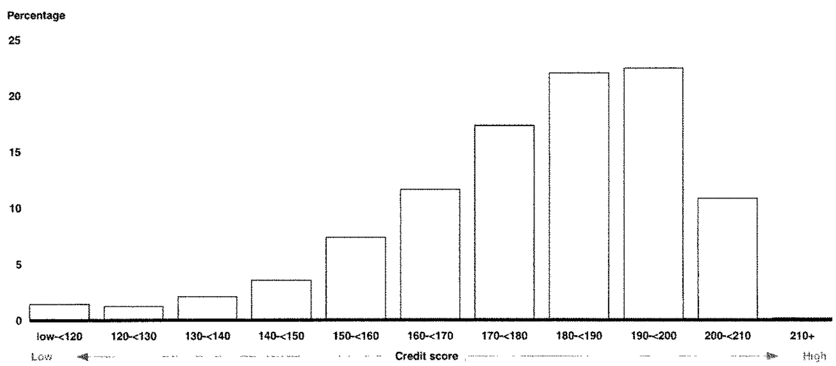
Source GAO analysis of SBA data

Figure 13: Percentage of 504 Loans by Gender of Ownership, 2001-2004



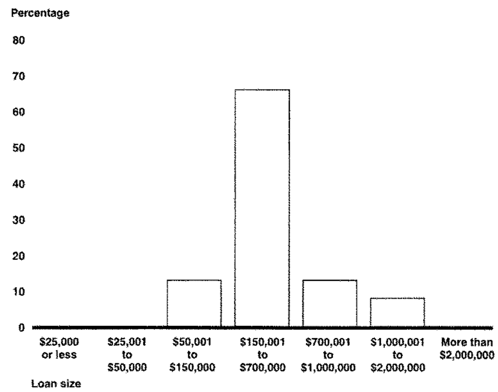
Source: GAO analysis of SBA data

Figure 14: Percentage of Small Business Credit Scores for Firms That Received 504 Loans by Credit Score Range, 2003-2006



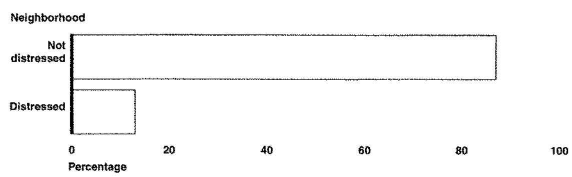
Source GAO analysis of credit scores for borrowers receiving 504 loans in SBA portfolio (2003-2006)

Figure 15: Percentage of 504 Loans by Loan Size, 2001-2004



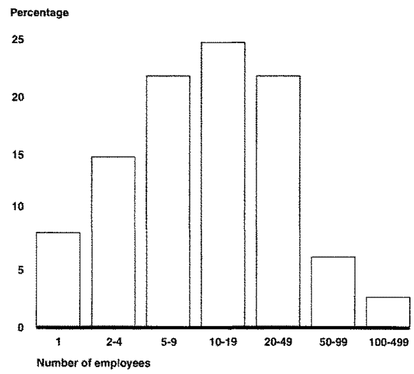
Source GAO analysis of SBA data

Figure 16: Percentage of 504 Loans in Distressed Neighborhoods, 2001-2004



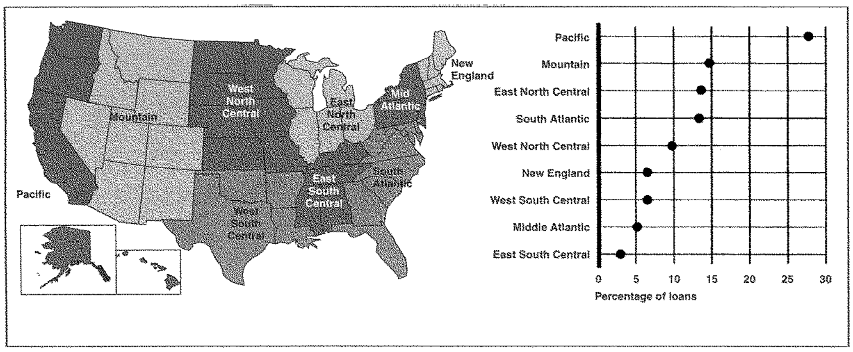
Source GAO analysis of SBA data

Figure 17: Percentage of 504 Loans by Number of Employees in the Firm, 2001-2004



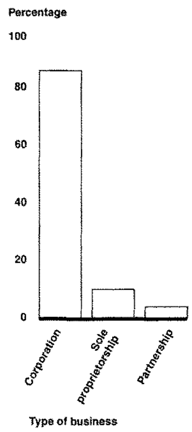
Source GAO analysis of SBA data

Figure 18: Percentage of 504 Loans by Census Divisions, 2001-2004



Sources: GAO analysis of SBA data, Art Explosion (map)

Figure 19: Percentage of 504 Loans by Business Organization Type, 2001-2004



Source GAO analysis of SBA data

Appendix IV: Comments from the Small Business Administration

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

JUN 2 9 2007

Mr. Daniel Garcia-Diaz
Assistant Director
Financial Markets and Community Investment
Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Garcia-Diaz:

We appreciate the opportunity to provide comments in response to the GAO draft report entitled *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance (GAO-07-769).*

We note that the report contains one recommendation. GAO has recommended that SBA complete and expand its current work on evaluating the 7(a) program's performance measures, and that as part of this effort, at a minimum, SBA should further utilize the loan performance information it already collects to better report how small businesses fare after they participate in the 7(a) program. We agree with the recommendation.

We have the following comments regarding the section discussing Small Business Predictive Scores (SBPS) credit scores which begins on page 27 of your draft report.

SBA disagrees with the main thesis of this section which states that GAO's "analysis of information on the credit scores of small businesses that accessed credit without SBA assistance showed only limited differences in these credit scores and those of small firms that received 7(a) loans." GAO states that the differences between 10 point score bands were "no greater than 5 percentage points," and the average difference "was 1.7 percentage points." However, the higher score bands (less risk) consistently show a lower percentage for 7(a); while the lower score bands (greater risk) consistently show a higher percentage for 7(a). It is in the riskier bands where the differences in the two portfolios are exposed. All portfolios end up with the bulk of scores around the middle or higher bands; the riskiness of a portfolio is determined by the distribution in the lower (riskier) bands. While the numbers have not been worked out, if other things were held equal, a shift in the credit scores distribution of this amount would likely cause at least a 10% difference in the number of loans going into default or purchased over a 12-month .period, and perhaps a 15% increase. Such a shift would not be insignificant.

As GAO has stated, the results of its analysis should be interpreted with some caution, particularly since D&B and FIC have stated that the FIC development sample was not statistically representative of all small businesses. Additionally, the SBPS sample includes only those lenders who agreed to be in the development sample. There may be a common factor

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Mr. Garcia-Diaz

among these lenders, which does not make them representative of all outstanding loans, let alone all small businesses. For example, only those lenders that focused on particular types of business (or other factors) may have felt the need for the credit scoring product. Further, banks typically do not score very good credits at all, so normal comparisons of portfolios would miss these loans, thus lowering a lender's average SBPS development sample scores and making their contemporary portfolio look worse than it really is by leaving the good credits out. It is possible that this effect is prevalent in the development sample as well.

Moreover, as GAO points out, the time periods of the two sets of credit scores are different. The FIC and D&B SBPS sample was from 1996 through 2000, and the SBA 7(a) sample was from 2003 through 2006. So the two samples could have loans scored as far apart as a decade. Too much can change in a decade to make the scores comparable. The 7(a) credit scores are SBA's "surrogate origination scores" which are the first scores after a loan is made, about one to three months after it is disbursed. The SBPS development sample credit scores are different types of outstanding loans and at various stages of loan aging, from a month or two to almost 30 years (if commercial real estate) when they were scored for the sample. Combine this with a possible 10 year difference between scoring dates, and this makes it possible that one sample may have some loans that are almost 40 years older than all of the loans in the other sample.

Finally, the 7(a) sample of small loans includes only small businesses which meet the SBA definition of a small business at the time of origination. Not only do businesses in the SBPS sample not have to meet the SBA definition of a small business, they do not have to be to small businesses at all. Some of the loans in the SBPS sample were likely made to businesses that may not have been small at the time of loan origination.

We are attaching additional technical correction comments to this letter.

Again, thank you for the opportunity to comment on this most important issue.

Sincerely,

Janet Tasker

Janet Tasker
Deputy Associate Administrator
Office of Capital Access

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear (202) 512-8678 or shearw@gao.gov

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In addition to the individual named above, Daniel Garcia-Diaz (Assistant Director), LaKeisha Allen, Benjamin Bolitzer, Christine Bonham, Tania Calhoun, Marcia Carlsen, Emily Chalmers, Elizabeth Curda, Julianne Dieterich, Carol Henn, Alison Martin, Jose Matos, Lisa Mirel, Marc Molino, Anita Visser, and Mijo Vodopic made contributions to this report.