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PROPOSED AMENDMENTS TO THE 7(a) AND 504 LOAN PROGRAMS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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HEARING ON PROPOSED AMENDMENTS TO THE 7(a) AND 504 LOAN PROGRAMS

THURSDAY, JUNE 24, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m., in room 2360, Rayburn Building, Hon. Jim Talent (chairman of the committee) presiding.

Chairman TALENT. Good morning, ladies and gentlemen, and welcome. Thank you for joining me this morning to examine the proposed changes to the 7(a) and 504 loan programs. I am certain that by working together we can continue to improve these vital programs and make them even more responsive to the needs of small businesses and lenders alike.

The proposed changes to the 7(a) program merit a brief description. It is suggested that the maximum guarantee amount on a 7(a) loan be increased to $1 million from the 1988 limit of $750,000 in order to keep pace with inflation. A parallel proposal exists for the 504 program. Another proposal suggests the removal of the provision which reduced SBA's liability for accrued interest on defaulted loans since the provision's intended savings have failed to materialize.

The 7(a) program is now facing a problem of early repayment of large loans which is jeopardizing the subsidy rate. The proposal before the committee seeks to remedy this problem by assessing a fee to the borrower or for prepayment within the first five years of a loan with a term in excess of 15 years. Another proposal seeks to stabilize the subsidy rate for the 7(a) program at 1¼ percent by requiring the administrator to adjust program fees.

This is similar to the current stabilization process for the 504 program. I am especially interested in hearing our witnesses comment on these two proposals. They seem to me to have merit but I hope that the committee focuses on them and asks any questions that members may have. Also, there is a proposal to modify 7(a) rules which prohibit loans for passive investment. When we last reauthorized the 504 program, we modified a similar restriction in order to permit the financing of projects where less than 20 percent of its space will be rented out when the small business in question will occupy the remaining space. We need to discuss providing similar options to 7(a) borrowers.

Allow me to also briefly describe the proposed changes to the 504 program. It is suggested that the maximum debenture size for public policy debentures be increased from 1 million to 1.3 million, and

that women-owned businesses be owned to the categories qualifying for these debentures. Currently the 504 program levies fees on the borrower, CDC and the participating bank. The bank pays a one-time fee whereas the borrower and CDC pay a percentage of the outstanding balance annually in order to provide operational funding for the 504 program.

These fees sunset on October 1, 2000, and it is proposed that we continue them through October 1, 2003. Additionally, it is suggested that we grant permanent status to the preferred certified lender program which will otherwise terminate at the end of Fiscal Year 2000. Finally to address the problem of low recovery rates on defaulting 504 loans, it is proposed that a permanent program be created to handle the liquidation of those loans. This would replace a pilot program created in 1997 and gives qualified and experienced CDCs the authority to handle the liquidation of loans with the approval of the SBA.

We have a number of witnesses, and I will introduce them later. First, of course, I will turn to my distinguished colleague, Ms. Velazquez for any opening comments she would like to make.

[Mr. Talent's statement may be found in the appendix.]

Ms. VELAZQUEZ. Mr. Chairman, first let me thank you for holding this hearing to examine proposed changes to the general business loan guarantee or 7(a) program and the 35 development company or 504 program. What we are doing today is updating and improving the 504 and the 7(a) loan programs to insure that they are run in a reasonable and thoughtful way. And today's hearing will present the committee with an opportunity to hear from the Small Business Administration, as well as the participants from each program on how to best accomplish this.

7(a) and 504 are two of the most important small business loan programs administered by the SBA. They represent access to capital for America's small businesses and access to capital means access to opportunity. Although SBA administers numerous programs that provide financial and technical assistance to small firms, the 7(a) program is the agency's flagship loan program. It is far and away the agency's largest and most important both in terms of number of loans and program level supported.

Under 7(a) loan guarantees are provided to small businesses that have been unsuccessful in obtaining private financing on reasonable terms. The profits from a 7(a) loan may be used for virtually any business purpose and have made the difference for countless entrepreneurs. Additionally, under 7(a) loans up to $100,000 are guaranteed up to 80 percent and loans over $100,000 are guaranteed up to 75 percent with the average guarantee being close to 76 percent. Nearly 7,000 banks and non-bank lenders are now approved to participate in the program.

Since the program's inception, SBA has made or guaranteed more than 600,000 7(a) loans totaling close to $80 billion. The 7(a) program addresses the financing needs of small firms that are often not met in the private capital markets. The reason for this is that commercial lenders often do not provide loans for the purposes in the amounts and with the terms required by small business borrowers.

Equally important, the 504 program serves economic development. Since 1980 more than $20 billion in fixed asset financing for over 25,000 small business concerns has been arranged by 35 development companies under 504. This represents $7.4 billion in CDC debenture authorizations and $12.6 billion in private sector and other financing. Currently the 504 program is supported completely by its fee system, and, therefore, requires no direct appropriations from Congress.

It is my hope that we can work together to maintain the zero net subsidy level for the 504 program. I can attest to the fact that the 504 program works. Just this week I visited a 504 loan recipient in my district. This business, an automobile dealership, will use the 504 loans to construct a new service center. This will enable the dealership to better meet the needs of its customers, and as a result expand its business, and it will also bring up to 50 new jobs to the community. This is why it is so crucial.

The businesses have access to the capital they need. When a business is able to expand everyone benefits. Although authorization for the 7(a) and 504 programs does not expire until October 1, 2000, it is important that we begin the process of reviewing these two programs now. The reason is that both lenders and potential borrowers need to have some assurance that the programs will continue to be authorized after October of 2000 and that it will be authorized at an adequate funding level. Therefore, this hearing is timely.

Mr. Chairman, I look forward to working with you as we move to reauthorize these two vital loan programs, programs that should be held out as an example of programs where taxpayers can see their dollars doing effective work. Thank you, Mr. Chairman.

Chairman TALENT. I thank the gentlelady as always. We have one panel today, and I do hope that members will focus, as I am going to have to leave for a few minutes, but these are important proposed changes and I would just really appreciate the members' attention to them. Our first witness is the Honorable Fred Hochberg, the Deputy Administrator for the Small Business Administration. It is a pleasure to have Mr. Hochberg with us, and before he testifies, I do feel I have to put something on the record.

We have had a pattern of problems from the agency with regard to the committee's rules regarding submissions of statements 48 hours before committee hearings. I am, as members know, the farthest thing from a stickler for formality. At the same time we do have to assume, and this may be more an abstraction than a reality, but we have to assume that somebody here might actually want to read the statement before we have a hearing, and we can't do that if we get it the night before.

This is a 26-page statement that we received I think at 8:00 last night. So I know this is well below your pay grade and everybody needs to know Mr. Hochberg came up and apologized to me beforehand. So I would just ask the agency, if in the future, if it could get these statements in, and at least give us 24 hours if not the 48, and I would be grateful for that and you could redeem yourself considerably, Mr. Hochberg, by summarizing your 26-page statement.

And I do appreciate your willingness, members need to know that Mr. Hochberg agreed to be on a panel with others and that was really for our convenience, so that we would not have to have two panels and two rounds of questioning.

Mr. Hochberg, it is a pleasure to have you here, sir.

STATEMENT OF HON. FRED P. HOCHBERG, DEPUTY ADMINISTRATOR, SMALL BUSINESS ADMINISTRATION

Mr. HOCHBERG. Thank you, Mr. Chairman. Congresswoman Velazquez and members of the Committee, and I do want to apologize for the lateness of our testimony. It was inexcusable and we will do better next time. Thank you for the opportunity to discuss the credit needs of America's small businesses. In my oral testimony I would like to touch briefly on some of the program initiatives SBA has developed to meet these needs.

I will also discuss the legislative proposals the Committee is considering. Both are addressed at length in my written testimony which I ask to be inserted into the record. The current budget environment makes it especially important that the agency operate in the most efficient and cost-effective manner possible. In its 7(a) and 504 programs, SBA is now delegating greater authority to its lending partners than ever before.

Today, with 19 percent fewer employees than in 1992, we rely on the credit decisions of our lending partners for about 75 percent of our loan approvals. This means that we must have the oversight tools necessary to ensure that we can better monitor the performance of our lending partners to protect the taxpayers' dollars. To this end, SBA's Fiscal Year 2000 budget request includes $8 million to continue the systems modernization efforts SBA began in Fiscal Year 1998.

When completed, we expect the system will enable us to better identify and manage portfolio risk. While improving the efficiency of the products we deliver is vital, we must also ensure that our products are tailored to meet the needs of the nation's small business community. One way that SBA has attempted to address this challenge is by expanding the range of equity vehicles and loan products and services. As you know, SBA has developed products from Microloans to LowDoc to SBA Express to increase the availability of smaller sized loans.

And of course our traditional 7(a) and 504 products are available to meet the larger capital needs of small businesses. SBA is constantly seeking new ways to make it faster and easier for small businesses to gain access to capital, yet small businesses, particularly newly established companies, tell us that the type of credit that continues to be the most difficult to get is in small amounts, typically up to $150,000.

Since 1953, SBA's mandate from Congress has been to fill credit gaps and to remove the barriers to entry faced by America's small businesses. Recently, Federal Reserve Chairman Alan Greenspan noted serious gaps still exist in access to capital for small businesses, especially for minority loan applicants. While the SBA has a very good overall record of increasing access to capital, I am convinced that we need to do more, especially for minority and women-owned firms.

To this end, SBA has been proactively reaching out to these constituencies. We have over 80 partnership agreements in place with business groups across the country designed to increase access to SBA's programs for all segments of society. Despite these best efforts, the percentages of SBA lending to these communities is simply not adequate. To remedy this, in the Fiscal Year 2000 budget, the President announced his New Markets initiative.

The initiative is a sweeping new public/private partnership designed to boost business opportunities and to meet the unmet needs of small businesses. One of SBA's proposed New Markets initiatives is a limited, New Markets Lending Company pilot program. Under this pilot, SBA will approve a small group of lenders to provide loans specifically focused on the New Markets small business segment.

Chairman Greenspan also noted that increased access to loans is not the sole solution to meeting the capital needs of small businesses. In various stages of development, many small businesses are not bankable. In many circumstances, small businesses need more patient capital in the form of equity or subordinated debt. To address this problem, SBA's Fiscal Year 2000 budget includes a number of proposals developed in consultation with venture capital experts to make it more attractive for Small Business Investment Companies and specialized SBICs to invest in distressed rural and urban areas.

The low and moderate income investment initiative compliments our existing SBIC program by offering a special Low-and-Moderate Income (LMI) debenture. The new tool allows SBICs to defer interest payments on LMI debentures for five years. To expand equity investments in LMI areas, technical assistance may also be needed. To do this, the SBA is proposing the creation of New Market Venture Capital Companies that will target investments in the range of $50,000 to $300,000. Modeled on existing SBIC programs, the New Markets Venture Capital Companies will form a new and separate venture capital network. The program will offer venture capital solutions along with hands-on technical assistance in low and moderate income areas.

Now let me turn to the proposed legislative changes to the 7(a) and 504 program. We are interested in the proposed legislative changes to the 7(a) and 504 programs provided that capital is made available to all small businesses, especially those smaller-sized businesses that are just starting out.

We are concerned that the proposals being discussed today appear to be directed towards the businesses and loans at the larger end of the spectrum. First, it has been proposed that the loan size be increased for both 7(a) and 504 programs. For 7(a) the proposal increases the maximum amount of loans that SBA can guarantee from its current $750,000 limit to $1 million. Coupled with this change would be the establishment, for the first time, of a maximum loan size of $2 million.

We feel that it is critical that consideration of any increase in loan size be coupled with the incentives we have proposed to encourage lenders to increase the availability of funds to smaller borrowers.

Chairman TALENT. Fred, you, or if you have staff here who would prefer to have them do it, tell us what the average guarantee rate is now and what the range is on these loans. Is it still about like—if one of the other witnesses wants to jump in here. I want to frame this for the members while this testimony is still fresh in their minds. The average guarantee was about 75——

Mr. WILKINSON. Between 72 and 73.

Chairman TALENT. Okay, 72, 73 percent but that is an average so some loans the government guarantees less and some it guarantees more, is that right, Tony?

Mr. WILKINSON. In the fiscal 2000 model it is 72.88.

Chairman TALENT. Okay. In some cases the government will guarantee more, in some cases less, is that right?

Mr. HOCHBERG. Up to 90 percent.

Chairman TALENT. Okay. I say this because as Mr. Hochberg testified correctly, we are talking about a cap of $2 million and a cap in the guarantee of $1 million, and there are cases where the government may only guarantee about 50 percent of the loan. That is worked out between the lender and the SBA on a per loan basis, is that how this——

Mr. HOCHBERG. On loans over $150,000 the maximum guarantee is 75 percent.

Mr. WILKINSON. That is correct, if the loan size stops at $1 million. You can do a $1.5 million loan with a 50 percent guarantee.

Chairman TALENT. Okay.

Mr. WILKINSON. But the maximum guarantee portion cannot exceed $750,000 today.

Chairman TALENT. Okay. But the minimum, it does sometimes go less than that obviously, a guarantee less than that. Is that worked out on a per loan basis?

Mr. WILKINSON. Well, again there have been loans in the past made for $3 million with a 25 percent guarantee.

Chairman TALENT. Okay. And again that is worked out on a per loan basis.

Mr. HOCHBERG. Well, I think what Tony is saying is that on the $750,000 we can guarantee up to $750,000 so on a $3 million loan only 25 percent is guaranteed.

Chairman TALENT. Right. You can't go higher than that. I see.

Mr. HOCHBERG. But we can only guarantee up to $750,000.

Chairman TALENT. I am sorry, but this clears something up for me. I ask the committee's indulgence. If it is a lower amount total than the loan, will you always guarantee like around 72, 73 percent?

Mr. HOCHBERG. With the SBA Express loans, which are primarily done by preferred lenders, we only guarantee 50 percent. The lender makes the credit decision using its own forms and processing. So we say in exchange for that expedited consideration, we will only give them a 50 percent guarantee.

Chairman TALENT. Okay. Thank you. I appreciate your clearing that up. You can continue.

Mr. HOCHBERG. We feel that it is critical that consideration of any increase in loan size be coupled with the incentives we have proposed to encourage lenders to increase the availability of funds for smaller borrowers. Furthermore, SBA believes it is important

for us to assess the possible adverse impact that the proposed increase would have on the availability of 7(a) and 504 program authority for Fiscal Years 1999 and 2000. SBA continues to support the present Fiscal Year 2000 budget which does not take into account these proposed changes.

The second proposal is the repeal of the mandate that the interest rate be reduced by 1 percent when a lender requests that SBA honor its guarantee of a defaulted loan. SBA would welcome additional discussion of this proposal and its potential impact with this Committee, OMB, and the lending community.

The next provision will allow the establishment of a limited prepayment penalty. While SBA understands the basis for this request, we feel if such authority is provided it should include a provision allowing SBA to repeal the prepayment penalty authority if warranted due to a change in economic conditions. We also feel that the Committee, SBA and our lenders should give consideration to alternatives to the prepayment proposal under consideration. These include for examples, making the fee optional for lenders, allowing the fee only on loans with fixed interest rates, or allowing the borrower to elect either a prepayment penalty or an up-front fee.

The fourth 7(a) legislative proposal is for the establishment of a subsidy rate floor of 1.25 percent. After consultation with the Office of Management and Budget (OMB), SBA believes that it must object to any proposal that would legislate a subsidy rate floor. The Chief Financial Officer Act requires every Federal agency to review its fee structure every year. If continued performance warrants it, SBA looks forward to being able to consider fee adjustments on their individual merits. We support the final 7(a) provision regarding the leasing out of an increased portion of the property consistent with the regulations that govern 504 loans.

Let me now turn to the provisions of the proposal addressing SBA's 504 program, a number of which we support. SBA supports the first 504 legislative provision which would increase debenture size. The second 504 proposed change is to include women-owned business development within the 504 program. We agree with this proposal. Furthermore, we believe veteran-owned business development should also be included among the program's public policy goals.

SBA agrees with the proposal to extend the sunset date of the 504 guarantee fee and the proposal to make the Premier Certified Lender Program (PCLP) permanent with some appropriate revisions. Under the next proposal SBA would be prohibited from selling any defaulted PCLP loans in an asset sale unless the responsible Certified Development Company (CDC) consented to the sale. SBA cannot support this. Asset sales are not intended to be distress sales. Given the critical importance of the agency's asset sales efforts, we do not believe that SBA should be legislatively restricted from including any class of loans in its sales.

Under the final provision, the current CDC liquidation pilot would be expanded and made permanent. An evaluation report is due to Congress by September 30, 1999. Preliminary indications regarding the success of the pilot are encouraging. Yet, we don't have the information and analysis necessary to make a definitive conclu-

sion. With that said, however, the agency does believe that it is appropriate to expand the pilot and make it permanent with appropriate safeguards.

In summary, SBA finds that many of the recommended legislative changes before this Committee have merit. We believe, however, it is important to the committee, the SBA and the lending community to work together to ensure that the proposals appropriately address the issues before us and that they do not result in any negative consequences.

We look forward to working with you on these issues. I very much appreciate your invitation for me to appear before you today. I would be happy to respond to any questions you may have.

[Mr. Hochberg's statement may be found in the appendix.]

Chairman TALENT. Thank you, Mr. Hochberg. Those were very helpful comments on the legislative proposals. I appreciate that very much. Mr. John Giegel, who is the president of the Wisconsin Business Development Finance Corporation. I am just going to go in order across the table.

STATEMENT OF JOHN M. GIEGEL, PRESIDENT, WISCONSIN BUSINESS DEVELOPMENT FINANCE CORP.

Mr. GIEGEL. Good morning, Mr. Chairman, and members of the committee. If it pleases the Chairman, I would ask that my written statement be inserted into the record. I am John Giegel. I serve as Vice President for Congressional Relations for the National Association of Development Companies, the trade association for SBA 504 Certified Development Companies.

NADCO represents 250 Certified Development Companies who provided 95 percent of all SBA 504 financing to small businesses during 1998. No other program can claim to have created over 500,000 jobs as the 504 program has done. I am also, by the way, the president and founder of Wisconsin Business Development Finance Corporation, Wisconsin statewide 504 Certified Development Company.

We have provided over $300 million in 504 and 503 financing to over 1,000 businesses since 1981. NADCO would like to thank you, Mr. Chairman, ranking member and the entire committee for your continued support of the 504 program and the CDC industry. It has been clear to us that the committee recognizes the value of the program to the small business community.

I come before you today with two purposes. First, we believe that there are areas in which the 504 program can be improved and extended to provide a greater scope of financial assistance to small businesses. Secondly, we feel strongly that action must be taken to deal with 504 loan recovery and portfolio loss problems. NADCO proposes to address these two issues through a legislative proposal we have provided to the committee, and I would like to summarize that proposal and its impact.

For the last 11 years, the maximum 504 debenture has been limited to $750,000. In 1990, 504 debentures impacting national objectives such as rural development were raised to $1 million. Given the fact, however, that 504 is targeted to real estate and major equipment purchases the rising cost of land, construction and ma-

chinery have impaired the ability of 504 investment to assist the small business owner.

Across the country 30 to 50 percent price increases over the past decade is commonplace. Therefore, we propose that the basic debenture size be increased to reflect at least the modest increase indicated by the Consumer Price Index to $1 million for regular 504 loans and to $1.3 million for projects with national objectives. Also, one of the fastest growing sectors of the business sectors is the woman-owned business. Many are at the stage requiring costly real estate and equipment to achieve the next stage of development.

We ask that the committee to support women-owned businesses by recognizing them as a national policy objective. I might also add that we would have no objection to including veterans as a national policy objective too. We also urge the committee to insure that adequate 504 guarantee authority and the necessary fees be reauthorized in this session, namely, $3.5 billion in FY 2001, $4 billion in FY 2002, $4.5 billion in FY 2003. The foregoing have addressed improving and extending the 504. Now I will summarize recommendations to improve 504 loan recoveries.

As noted in SBA's FY 2000 budget, loan defaults have dropped from 18.9 percent to 12 percent in four years. CDCs and the SBA are delivering an improved program and the Office of Management and Budget is better able to forecast default rates, so costs have declined for the small business owner. However, the same budget also states that recoveries on 504s are in fact much less than the 44 percent previously thought and perhaps as low as 23 percent.

We believe that this trend must be addressed and reversed now. Delay will have a serious impact on the 504 program and its availability to the small business owner. Since 1994 legislation has authorized the Premier Certified Lender Program. The program allows experienced CDCs to underwrite 504 loans without SBA provided that they reimburse SBA for up to 10 percent of any debenture loss. This program has operated for nearly six years now, reducing processing time and SBA personnel time and has not resulted in any increased losses to the government.

Chairman TALENT. Mr. Giegel, I want to emphasize something here just so the members here understand the potential problem. The default rate is going down but the amount that we are recovering when there is a default is also going down significantly which means that this being pretty good economic times we are okay but if we hit some bad economic times we are going to have to recover something on these defaults or this program is going to be in trouble. I mean is that a pretty good summary of what you are saying?

Mr. GIEGEL. Exactly, Mr. Chairman.

Chairman TALENT. So you are saying the committee needs to figure out and the SBA needs to figure out why we are not recovering on these defaults and we need to fix it before something happens to the economy.

Mr. GIEGEL. Correct.

Chairman TALENT. Which we all hope, you know, we all hope the business cycle has been repealed but none of us can count on that. I want the members to focus on that because we need to do something about it. Go ahead.

Mr. GIEGEL. One reason why CDCs do not participate in the program is because of SBA's reluctance to allow the Premier Lender to be able fully to carry out recovery efforts. Therefore, we do ask that the committee act now to make the Premier Certified Lender Program permanent and to direct SBA to provide comprehensive Premier regulations within 120 days.

Finally, Mr. Chairman, in 1996 legislation mandated a loan liquidation pilot program under which qualified CDCs would receive a delegation of authority from SBA to liquidate but not litigate loan recoveries. CDCs recognizes that with the prospects of government downsizing, we need to step up to safeguard the 504 program. We recognize that SBA portfolio personnel were immensely more experienced in liquidation but even in 1996 caseloads per worker per office meant long delays.

In liquidation time is money. CDCs have more resources for expeditious recovery and can concentrate on many fewer cases. Preliminary results are favorable and many CDCs in the pilot program have already shown the ability to perform rapid professional workouts in asset recoveries. We strongly urge the committee to make permanent the liquidation pilot and endow capable CDCs with full liquidation and litigation authority.

As you can see, Mr. Chairman, there are many issues to be addressed for the 504 program if we are to both improve it and stabilize the declining loan recovery. NADCO supports the legislative proposal provided by your staff. However, we urge you to include in your proposal our proposed authorization levels for the succeeding three years. We strongly ask the committee to take up consideration of our legislative package during this session, and we thank you for allowing us to come before you today to make comments. CDCs are major stakeholders in the 504 program. We want to do everything we can to insure its long-term viability. I would be pleased to answer any questions.

[Mr. Geigel's statement may be found in the appendix.]

Chairman TALENT. Thank you, Mr. Giegel. When the questions time comes, I am going to ask you to comment on Mr. Hochberg's comments about the proposal that we stick the agency's ability to sell defaulted loans. The agency is very strongly opposed to that. Our next witness is Mr. Wilkinson, Anthony R. Wilkinson, President and Chief Executive Officer of NAGGL. Tony, go ahead.

STATEMENT OF ANTHONY R. WILKINSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF GOVERNMENT GUARANTEED LENDERS

Mr. WILKINSON. Thank you, Mr. Chairman, Ms. Velazquez, and other members of the committee. So Mr. Hochberg does not feel alone today, let me issue my apology as well, because my disclosure statement was not attached to my testimony, so I thought I would just do that verbally on the record that neither I nor NAGGL have received any federal——

Chairman TALENT. Misery has company. That is fine.

Mr. WILKINSON. We have no federal grants or contracts. We have signed a co-sponsorship agreement with the SBA whereby in ten cities across the country this year we are putting on training for lending to new markets. With that I will get into my testimony. I

want to thank you for holding this hearing today. I want to commend you for your efforts to move forward this year on a reauthorization bill for the SBA programs.

Earlier this year NAGGL shared with both the majority and minority staff of the committee and with the SBA our association's proposed legislative package and I would like to briefly go through those. First, as has been mentioned, we are proposing increasing the maximum guarantee on an SBA 7(a) loan from $750,000 to $1 million. The last time this number was changed was in 1988 and just using the Consumer Price Index from the first of 1988 to the first of 1998, that amount would have increased to in excess of $1,050,000 and if you apply projected CPI increases to the first of 2000 we would probably get closer to a $1.1 million but our recommendation is to increase the maximum guarantee up to $1 million.

This increase in the maximum amount guaranteed would likely result in some new loan demand and we estimate that that additional demand would be in the range of $400 million per year. We also point out that this proposal would have a positive subsidy rate impact since these loans are subject to the highest tier of guarantee fee which is 3.875 and thus will generate additional cash flow into the subsidy model hence reducing the subsidy rate.

Along with the $1 million guarantee, we propose capping the maximum loan size at $2 million. This too should help control loan program usage and help cover some of the demand increase that would happen with the $1 million guarantee. Next we need to deal with a prepayment issue. A substantial number of borrowers are obtaining long-term SBA financing but then prepaying it during the first few years after obtaining a loan.

NAGGL is concerned about this. We believe that if the prepayment problem continues there could be serious policy consequences. A substantial portion of the income received by SBA on subsidy loans comes from a 50 basis point fee on the outstanding balance of the loan. If prepayments continue, the income to the government declines. That means the value of that 50 basis point fee in the subsidy model would decrease and future program users could have to absorb higher fees or we would be asking Congress for more money to hit a certain program level.

NAGGL believes that the cost burden of prepayments should be borne by those who choose to prepay, not on future program users. Our proposal is to establish a prepayment penalty. This penalty would be payable to the SBA, not to an investor, not to the lender, but to the SBA by a borrower who elects to make within the first five years of the loan an excessive prepayment on a long-term loan, and we are saying a long-term loan being a loan with an original maturity of 15 years or more.

The phrase excessive prepayment would mean an amount in excess of 20 percent of the outstanding loan balance in any calendar year. So a borrower could still pay down extra amounts over the regular scheduled principal as long as they did not pay more than 20 percent in any one year. The rate of this fee would be determined by the date of prepayment, 5 percent in the first year, 4 percent in the second year, 3 percent in the third year, 2 percent in

the fourth year, and 1 percent in the fifth year, and then after the fifth year there would be no prepayment penalty.

Prepayments on conventional commercial loans both fixed rate and variable rate are common. Furthermore, we note that SBA's 504 loan program has a prepayment penalty and that the Business and Industry Loan Program in the Rural Development Division of the Department of Agriculture also provides for a prepayment penalty. We believe that this proposal is a sound one. It is in the interest of the program and in the interest of future borrowers as well.

Chairman TALENT. Mr. Wilkinson, could you take a minute because this is a proposal that I want the committee to focus on. Give us a concrete example of the kind of prepayment abuse, if we can call it that, that you believe is now occurring. Can you do that off the top of your head, a hypothetical situation?

Mr. WILKINSON. A typical transaction would be a borrower obtains a 20- to 25-year 7(a) real estate loan that after two to three years another lender comes along and offers to refinance at different terms, and this is happening more often than we have seen in the past. Before the institution of the 50 basis point fee it really didn't matter. Now those prepayments have an impact on the subsidy model and we need to address that.

Chairman TALENT. All right. Go ahead.

Mr. WILKINSON. NAGGL believes that it is time, as further reductions are made in the 7(a) subsidy rate, to begin to reduce program fees. Currently, there is a one-time guarantee fee imposed on the borrower, the amount of which is determined by the size of the loan.

Chairman TALENT. Let me jump in a second because—I am sorry for the committee but I really want the committee to focus on this and I want to make sure I understand it. That 50-point basis fee is the new annual fee, not just the up-front fee, which is my question because that is already paid and gone but——

Mr. WILKINSON. 50 basis points would mean a half percent per year.

Chairman TALENT. All right.

Mr. WILKINSON. Paid on the balance of the loan.

Chairman TALENT. And the subsidy rate is calculated on a certain amount of receipts from those basis points and when they prepay they don't have to pay the basis points so that screws the model up.

Mr. WILKINSON. The model assumes a certain level of maturity in the loans and if those maturities don't materialize and are actually shorter then the net present value of that half percent per year is going to shrink.

Chairman TALENT. Okay. I am going to ask you what you think of Mr. Hochberg's suggestions for alternatives to try and control that so be thinking about that when you finish your testimony. I will be quiet and let you all testify. Go ahead.

Mr. WILKINSON. Back on fees, NAGGL believes it is time, as further reductions are made in the 7(a) subsidy rate to begin reducing program fees. Currently, there is a one-time fee imposed on the borrower, the amount of which is determined by the size of the loan. Except for loans with guaranteed portions of $80,000 or less which have a 2 percent guarantee fee, borrowers are required to

pay 3 percent on the first $250,000 guaranteed, 3.5 on the second $250,000, and 3.875 on the amounts above $500,000 guaranteed.

In addition, as we discussed, there is an ongoing half percent per annum fee on the outstanding balance of the loan that is paid by the lender for the life of the loan. In recent years, the 7(a) subsidy rate has fallen due to improved underwriting and program improvements. However, federal funding for the program has also declined and hence program participants have reaped no benefits from an improving program, and we believe that borrowers should receive some of the benefits and that it is time to begin to look at reducing program fees.

Accordingly, we have proposed establishing a 1¼ percent subsidy rate floor. We do not view this as legislating a subsidy rate but rather the subsidy rate would continue to be calculated as normal and if it fell below a subsidy rate target then the administrator at SBA would start reducing fees so that the subsidy rate would move back up to the 1¼ percent target.

If broker performance continues to improve or Congress enacts our legislative proposals for the increased loan size or prepayment penalty there will be additional cash flow for the government and we believe SBA should be directed to begin a staggered reduction in the amount of fees paid by borrowers. First, as monies would be available, we think the rate on the first $250,000 guarantees should be reduced to 2 percent. As more money becomes available, that the second $250,000 guarantees could be reduced to 3.

The amounts over $500,000 at some point in time could be reduced to 3½, and way down the road we could take a look at reducing the 50 basis point lender fee. These initiatives are interrelated in that they together would help eliminate program abuse while enhancing program use for future borrowers. We have three other legislative recommendations. First, in 1996 as part of the changes designed to reduce the 7(a) subsidy rate legislation was enacted to reduce the amount of the claim against SBA in the event a loan defaulted. We call this the default loan provision.

We thought this would reduce the subsidy rate. It has not and very simply the cost of compliance far outweighs any benefit we are getting and we ask that this be repealed. Second, we ask that the 7(a) program be allowed the same leasing provisions that were passed in the 504 program in 1997. And, third, we would recommend the following authorization levels be included in your reauthorization bill, $14.5 billion in fiscal 2001, $15 billion in fiscal 2002, and $16 billion in fiscal 2003.

And we would ask you to note that we are recommending flatlining the authorization level from fiscal 2000 to 2001 as Congress has already authorized a $14.5 billion program level for fiscal 2000. Thank you, Mr. Chairman, and I will be happy to answer any questions.

[Mr. Wilkinson's statement may be found in the appendix.]

Chairman TALENT. Thank you, Mr. Wilkinson. And our last witness is Ms. Donna Faulk, who is the Chair of the Government Business and Loan Committee of the Bond Market Association, also Vice President of Prudential Securities, and we appreciate your taking the time to come down and give us your testimony, Ms. Faulk.

STATEMENT OF DONNA FAULK, CHAIR, GOVERNMENT BUSINESS AND LOAN COMMITTEE, THE BOND MARKET ASSOCIATION

Ms. FAULK. Thank you, Chairman Talent. I appreciate the opportunity to be here this morning to discuss the possible improvements to the SBA's section 7(a) guaranteed loan program. I am the Chair of the Government Business Loan Committee of the Bond Market Association. This association represents both banks and dealer firms who are active participants in the bond markets. Our particular committee, the Government Business Loan Committee, is composed of representatives from firms that are active in the secondary market for loans guaranteed by the SBA section 7(a) program and for the securities that are backed by these loans.

We believe the 7(a) program continues to accomplish its intended goal of providing long-term financing for the small businesses who otherwise will not be able to find or qualify for term financing. The program generally operates efficiently and soundly. An active and robust secondary market in 7(a) loans has been and remains a key contributor and facilitator to the success of the 7(a) program.

As long as investors continue to view 7(a) loans as sound investments, they will continue to provide capital to the program at attractive terms for borrowers. As well as the 7(a) program functions there is always room for improvement. We strongly support the draft legislation containing proposed changes in the 7(a) program. We especially support the proposal for modest graduated prepayment charges on the 7(a) loans.

We believe that the prepayment proposal would strengthen this program and bring it more in line with Congress' original intent. The main beneficiaries for this prepayment proposal would be the small business borrowers whom the program is designed to assist. In a program like 7(a) prepayments can in some cases be a sign of success. If a small business meets with unanticipated success it may be in a position to repay its debts earlier than expected.

However, we are seeing an alarming rate of prepayments in the 7(a) loans that suggest not success but misuse. It is becoming increasingly common for 7(a) borrowers to pay off 15 to 25-year loans in the first few months, not the first few years, the first few months, of their terms. This is directly counter to the intended goals of this program. These prepayment patterns also threaten the program's efficiency and viability for borrowers by raising risks for loan investors.

As investors perceive the 7(a) loans as subject to extraordinary prepayment risks, they will demand higher rates of return as compensation. In the end, small businesses will suffer through higher financing costs. The prepayment proposal contained in this draft legislation would provide several benefits. First, it would discourage early prepayments on 7(a) loans without penalizing the true small business borrower who as a result of his success will be able to prepay his loans later in their terms.

Second, it would help insure that Congress' intent in reauthorizing the 7(a) program to provide long-term financing for the needy small business is met. Third, it would in the end, reduce costs for small business borrowers. We have seen this effect in most lending markets when prepayment charges are introduced, interest rates

on loans fall because investors perceive the loans as less risky. Finally, the prepayment proposal will help address the most troubling aspects of SBA's treatment of premium warranty refund payments.

We believe the prepayment proposal contained in the draft legislation would be a reasonable and welcome improvement to the 7(a) program. We urge this committee to adopt the proposal. Thank you for the opportunity to hear me today. I would be happy to answer any questions.

[Ms. Faulk's statement may be found in the appendix.]

Chairman TALENT. All right. I thank the witnesses. Let me just ask a couple questions before recognizing the ranking member. Fred, I know you are concerned about with regard to the increase in the guarantee amount to keep pace with inflation, that it may have a tendency towards encouraging larger loans which is moving in the opposite direction than the agency wants, and I agree.

Now how does the cap on the total size of the loan affect your consideration, and that seems to me to be kind of a reasonable trade-off. We increase the amount that can be guaranteed but cap the total amount at $2 million because right now there are loans above $2 million so at least we get rid of those big real estate loans and that sort of thing. What is your feeling about that as a trade-off?

Mr. HOCHBERG. Well, Mr. Chairman, the cap of $2 million certainly is a help and a move in the right direction.

We don't have a real objection to the $1 million level. Our concern is whether it can be coupled with enough incentives to assist smaller borrowers. Our proposal to help smaller borrowers with credit amounts up to $150,000 would reduce the fee to these borrowers by $1,000 and would reduce that ongoing fee we talked about from 50 basis points to 30. It would also reduce the ongoing fee to the bank by about $300 in the first year.

So as long as we have provisions to assist those seeking to get these more difficult to obtain smaller loans, we don't have an objection provided it is within our budget proposal for this year. Our projections of how much we need for Fiscal Year 2000 did not take into account doing $1 million loans.

Chairman TALENT. Sure. That is a very reasonable concern. What about that, Mr. Wilkinson? I mean, first of all, is a possible solution to that to postpone implementation of the increase until after this Fiscal Year so that we don't have those concerns? Do you think that is necessary, number one. Number two, what about Mr. Hochberg's statement regarding incentives for the smaller loans as part of this? Do you want to comment on that?

Mr. WILKINSON. We would be happy to delay implementation until the first of the next Fiscal Year. NAGGL has been front and center in each of the discussions to talk about incentives for small loans. I would be remiss if I didn't take the opportunity to say one of the biggest barriers we have in coming up with incentives on small loans is our subsidy model, and the overestimate of default that it wouldn't be as continually used.

And I will take us back to 1997 where we started out with a subsidy rate estimate of 1.93 and a default rate of in excess of 15 percent. That default estimate is now already down to 10 or below and

the subsidy rate is now predicted to be .44. So we have got the OMB side of the Administration taking money away from us at a time when we are trying to come up with incentives. So our concern about the Administration's proposals is that they are very expensive. It would take the subsidy rate from 1.16 percent up to 1.51 and without additional appropriations would shrink the program size.

Chairman TALENT. Yes. Well, you know——

Mr. WILKINSON. We would rather look at ways to provide incentives that are a little less costly.

Chairman TALENT. We are all victims of OMB. It is just terrible. And there is a point at which I am going to—we need to revolt here and maybe we need to contact Budget Committee staff because that is the block here and maybe have a joint hearing or something. I want them to protect the *"fisc"*. I think we all do. This consistent overestimation just inhibits the goals that we share on both ends of Pennsylvania Avenue about getting these loans to smaller borrowers.

Fred, you will take back to Ms. Alvarez our desire to help out with that. I know you all are sort of caught in the middle, but just year after year we get this and it is a concern. And we really ought to try and do something to apply some pressure. Mr. Hochberg, on prepayment, what do you—are you all trying to develop any regulations and maybe, Ms. Faulk and Mr. Wilkinson might want to comment on this too, do we need to do anything statutorily? Can we do this by regulation?

Mr. HOCHBERG. I will have to ask Jane Butler, who is our Associate Deputy Administrator for Financial Assistance, whether we can do this.

Ms. BUTLER. I am Jane Butler, the Associate Administrator for Financial Assistance. Our Office of General Counsel believes legislation would be required because all of the 7(a) program fees exist because of legislative authority.

Chairman TALENT. Okay. Ms. Faulk, they are repaying this in months, a matter of months——

Ms. FAULK. That is correct, sir.

Chairman TALENT. So this is obviously a deliberate thing. I mean they are borrowing this money with the intention of prepaying.

Ms. FAULK. That is why we call it a misuse.

Chairman TALENT. And what is it about the market that is permitting that, whereas, it didn't permit it a few years ago, or are they just awakening to this possibility now? What has changed so that they can do this now?

Ms. FAULK. In terms of the early prepayment?

Chairman TALENT. Yes. Is it the interest rate change or something that is making this financially attractive to these borrowers or what is it?

Ms. FAULK. I think that is part of the problem or the solution that the economy has been good. There is flush cash among the banking institutions. But it is also a situation where the lender, who is going to refinance the existing SBA borrower, is not going to do the start-up operation, is not going to do the credit quality review to get the SBA guarantee. He is going to cherry pick that loan after it has been done through the SBA program.

Chairman TALENT. Also they are saving on some transaction costs. They let the SBA lender——

Ms. FAULK. And that is due in part to this good economy and then the borrower is also, we consider it misusing the program for, as we say bridge or construction financing that if he is repaying in two to three months because he has found a buyer for his start-up operation is complete.

Chairman TALENT. Okay. So he gets the buyer and then he gets the cash to prepay.

Ms. FAULK. He gets the construction complete and he gets the buyer take-out. And he is flipping the property.

Chairman TALENT. Okay. I will recognize the gentlelady from New York.

Ms. VELAZQUEZ. Thank you. Mr. Hochberg, during this committee's hearing on SBA FY 2000 budget, the agency was asked whether publication of the 7(a) borrower information on the Worldwide Web for Freedom of Information Act reasons was contributing to the 7(a) prepayment problem. What have you found out?

Mr. HOCHBERG. Congresswoman Velazquez, data on loan approvals is public information, and as a result, it is my understanding that it does not come under the Freedom of Information Act. Therefore, we have a policy that all public data is made available either by writing to request it from the agency or accessing it via the Internet.

Ms. VELAZQUEZ. Let me ask you, do you need to publish all information, all the borrower information, you currently publish or could the agency modify this information and help alleviate this targeting by conventional lenders?

Mr. HOCHBERG. It is my understanding we need to make all public information available. I would be happy to look into that to see if it can be modified in some way so that it is not as fully disclosed.

Ms. VELAZQUEZ. One of my concerns is that I want to see the 7(a) program continue to offer smaller loans to small businesses that really have no other borrowing alternative. If the committee were to support the proposal to increase the amount of the maximum exposure for 7(a) loans from the current 750 to $1 million, what suggestions would the agency make without increasing the 7(a) subsidy rate that might induce lenders to make more smaller loans?

Mr. HOCHBERG. Any time we offer an incentive it does cost money. There is no way to offer an incentive without any cost. Our proposal for Fiscal Year 2000 reduces the fees to the borrower on $150,000 as much as $1,000 and reduces the ongoing fee the bank would pay by $300 in the first year. It does have an impact on the subsidy rate, but that has already been incorporated into our proposal for this year. So there is no additional cost.

Ms. VELAZQUEZ. In response to a question that I sent to your agency as a follow-up to this committee's hearing on the SBA FY 2000 budget, the agency replied we are pleased that the subsidy rate and offsetting fees for the 504 program have decreased over the past several years. In the future we will continue our efforts to reduce purchases and increase recoveries to further drag down program costs. We are supporting the 504 pilot liquidation program. What SBA specific efforts to reduce purchases and increase recoveries?

Mr. HOCHBERG. That is going to be the lion's share of it in terms of reducing those kinds of fees. We are also hopeful that under the Premier Certified Lending Program that we can achieve more efficiencies and we can provide each CDC with more authority as we have done on the 7(a) side.

Ms. VELAZQUEZ. Is the 504 liquidation and recovery a stipulated priority for SBA district offices?

Mr. HOCHBERG. We have the CDC liquidation pilot on which we will be giving a full report to Congress at the end of September. The results have been very positive. Notwithstanding the fact we don't have the full report, we are ready to go forward and give that authority over to the CDCs.

Ms. VELAZQUEZ. Mr. Giegel, are you and your colleagues seeing any improvement in the Small Business Administration loan liquidation and recovery efforts and specifically what is your assessment of the pilot liquidation program?

Mr. GIEGEL. CDCs, particularly those who have volunteered to participate in the pilot liquidation program, have had some excellent preliminary results. Our CDC just obtained a 100 percent recovery on a project that we have had in the pilot liquidation program, and we worked very closely with the agency in maximizing recoveries. I will say in our district the two senior portfolio managers have retired in the last couple of years and the liquidation staff has not been increased.

So the case load per worker per liquidation officer has increased in our district and that naturally this is a concern that there are not going to be more liquidation personnel from SBA, that their case loads will increase and that we can discern no particular priority for 504 recoveries. And, in fact, being in the second position often there is more difficulty in recovery that they perhaps don't get the attention they could deserve.

Now CDCs and our own included, we have very few cases, fortunately, and that is pretty representative industry wide and we can devote more resources at a very early stage in these recoveries and recover faster.

Ms. VELAZQUEZ. Would you make any changes to these programs? Would you recommend any changes?

Mr. GIEGEL. Well, the primary improvement is to allow CDCs, capable CDCs, to litigate as well as liquidate. Right now we do not have the authority to litigate. And in states such as Wisconsin, we have to literally turn over all documentation when we get to that point to the SBA to litigate. And that becomes an involved process with the federal attorney and priorities slip even further. So we get time lines a year, 18 months, in which recoveries become smaller and smaller.

Ms. VELAZQUEZ. Mr. Hochberg, would you like to comment on that?

Mr. HOCHBERG. SBA's district directors give an equal priority to liquidation. There is no priority put on one type of loan versus another. In fact, on a quarterly basis they review all liquidations that are over 180 days old.

We are also trying to change our standard operating procedures to give field offices far more flexibility to handle liquidations. And again as I mentioned, we want to go forward with this pilot and

make it permanent which would in some way take care of this problem entirely.

Ms. VELAZQUEZ. Thank you. Mr. Wilkinson, if this committee were to support the proposal to increase the maximum SBA exposure from $750,000 to $1 million, what proposal would you be willing to accept to make sure that the larger loan size does not consume the program level?

Mr. WILKINSON. Well, first of all, the $1 million guarantee, in and of itself, should reduce the subsidy rate and a lower subsidy rate in turn would create more program levels so part of the increase in the demand would come from the reduction in the subsidy rate. Second, the $2 million loan cap will cover a significant portion or a good portion of the increase in loan volume. And, third, we would just need to watch volume.

It is really difficult to predict exactly how much loan volume we would have, and if we started to have significant problems we would sit down and come up with some kind of solution maybe, defer that side of the guarantee until there is enough loan authority.

Ms. VELAZQUEZ. Mr. Hochberg, I have a last question and it is regarding the new market initiatives, and I hope that soon we will be able to announce it. Will the investment of this company be focused only in the areas designated as LMI?

Mr. HOCHBERG. The New Market Lending Company proposal, the LMI debenture program, and the New Market Venture Capital initiative are focused on low and moderate income areas.

Ms. VELAZQUEZ. What is the percentage of that? What would represent the percentage?

Mr. HOCHBERG. I am not sure I understand the question.

Ms. VELAZQUEZ. In terms of low income areas, how much of this new market venture capital will be invested?

Mr. HOCHBERG. Our proposal for Fiscal Year 2000 is for $100 million for this program.

Ms. VELAZQUEZ. Tell me 80 percent, 90 percent, 100 percent in low and moderate income areas.

Mr. HOCHBERG. I am not sure I have the answer to that question. I am going to have to get back to you on what portion needs to be invested in LMI areas.

Ms. VELAZQUEZ. With that answer will you please include what is the rationale for it?

Mr. HOCHBERG. Certainly.

Ms. VELAZQUEZ. Thank you.

Chairman TALENT. Along those lines, Fred, let me ask you, are you getting consulted by Treasury in development of this New Markets initiative?

Mr. HOCHBERG. Are we being consulted by them?

Chairman TALENT. Yeah. I mean is the Treasury—are you all having a lot of input into how this thing is being developed?

Mr. HOCHBERG. The three pieces that we really have responsibility for, the Low and Moderate Income Debenture program, the New Markets Venture Capital Program, and the New Markets Lending Companies are all SBA initiatives.

Chairman TALENT. That is your deal?

Mr. HOCHBERG. That is our deal and we have experience in every one of those.

Chairman TALENT. Yeah, that is true. Okay. I just was concerned because——

Mr. HOCHBERG. The only one that we don't have is the Americas Private Investment Companies (APIC), which is HUD's program.

Chairman TALENT. Okay. I recognize the other gentlelady from New York, Ms. Kelly, one of the other gentleladies.

Mrs. KELLY. Thank you very much, Mr. Chairman. Mr. Hochberg, I am interested in a piece of information, that I really was rather unaware of that I read in Ms. Faulk's testimony, and that is the premium refund question. I was unaware that the premium refund payments that are paid back to the SBA are diverted to the master reserve fund. I want to know why you decided in the case of the premium pools that any premium refunds paid by the lender should not be passed on to the investors. Can you give us an explanation for that?

Mr. HOCHBERG. I am going to ask Jane Butler to give me a hand on that one.

Ms. BUTLER. The documents for the individual loans sold in the secondary market include a specific provision whereby the refund would go directly back to the investor. The documents related to the pooled loans don't discuss at all any premium refund. All they promise is that the pool holder will receive principal and interest on a timely basis whether the borrower makes payments on time or not. So the practice is in concert with the way the documents read.

Mrs. KELLY. Who would have wrote the documents?

Ms. BUTLER. This was done in consultation between the industry and SBA. This provision was actually added in 1984. We received legislative authority, but the legislation specifically directed that the pool program be established at no cost to the government. The premiums that SBA receives from prepayments on pooled loans are included in, but do not represent a large portion of our account but they do help to keep the costs of the program at a zero rate. If we did refund the premium, one of the issues has always been how to make such distributions on pooled loans to the multiple investors that may be involved.

And also an issue is that there are special benefits that come to a pool investor, and then there are some things that are not as beneficial, so they receive some benefits by being an investment pool as opposed to an individual purchase.

Mrs. KELLY. Ms. Faulk, would you like to address that?

Ms. FAULK. Yes. I would. First of all, we do not believe that the contractual obligation of the 1086, SBA 1086 contract for the single loan going into the pool security negates the refund of that premium to the premium investor. We are confused, as well, regarding the SBA's position that if I didn't put it in a premium pool but I put it in a par pool and the premium exposure is in IO holder has a certificate that has no language, as well, that says that they are privy to the return of the premium.

Mrs. KELLY. So it sound as though there needs to be a better writing in that documentation. Is that correct?

Ms. FAULK. We believe that the funds should flow back to the premium investor, as well as to the IO holder of a single IO or to the multiple strip holder of a certificate that as well does not have any language giving them provision for the return of the premium.

Mrs. KELLY. I would like to have some clarification, a further clarification, from the SBA on how that situation could be rectified. I tend to agree with Ms. Faulk. I think that there needs to be something in the language so that these investors have some understanding. If it is not printed in the document, then perhaps it should be printed in the document that this is actually what is happening, so that the investor understands up front fully in writing.

The other thing I am interested in, I am wondering if the solution on this whole prepayment problem could lie within the structuring of banking laws and not with one more law of prohibition coming out of with regard to the Small Business Administration. I am not sure, but I am concerned about that, because when you talk about the way it works with the business needing to get the money, the banks are often loathe to loan the money to a NAASA business given a number of other situations with regard to their inspectors and so forth.

Once there is a loan made anywhere, then there is a credit established. Then that person who has gotten that loan can go out and get something that the banks will feel comfortable about securing. I have heard repeatedly from small businesses in my district that this is one of their problems. I understand, and I am in general agreement on the prepayment problem, but I have a concern about that.

I also am concerned, which is a fact that I have also heard from my small businesses, about the fact that the SBA people are telling my small businesses that it is easier for them to make a half million dollar loan. It is just as easy for them to do that as it is to make a $50,000 loan on a program or for these security things.

I am very concerned that if we raise the limits that we are not going to stay with our really small beginning businesses, because that is where the money needs to stay focused, so there is two main areas that I have of concern here, not necessarily related, but I would like you, Mr. Hochberg, to kind of address those.

Mr. HOCHBERG. Well, I share your concern about the smaller sized loans. That is why we have worked hard to come up with a proposal that would give a greater incentive to both individuals and banks to make smaller sized loans. The transaction cost is not that different in terms of preparing a loan for $100,000 to $150,000 to $500,000. There is an inherent fixed cost and that is why we have been trying to reduce it for the smaller sized loans.

In terms of prepayment, an SBA borrower pays substantial fees up front. I am sure there are cases where borrowers prepay in a few months, but they have already just paid what could be a fee as high as 3.875 percent, so there is some disincentive against prepayment. I should just add this point for the Committee to consider. When businesses can use conventional financing instead of SBA guaranteed loans, that isn't all bad. There is some advantage when the small business community does not have to rely on the

SBA. Ultimately we hope that business can move to a reliance on conventional financing.

Mrs. KELLY. Ms. Faulk, do you want to respond to any of that?

Ms. FAULK. Yes. Again, the major problem that we see when that small business borrower takes out that long-term debt and prepays it in a relatively short time, and I am talking three to six months, the bottom line it hurts the true needy small business borrower because we are allocated precious few guaranteed dollars. This is a small program of $10 billion.

When that borrower misuses these term dollars and prepays quickly that is not going back into the coffer for the needy small business borrower when he needs it. It is gone. It is dried up. And that small business borrower abused the program, and if we have statistics from Cost Colsin Services Corp., the SBA transfer agent, and looking particularly at that large loan, that 500 to 750,000 guaranteed loan, that in fiscal 1998 the loans in that range in the first six months $24.5 million prepaid in those large loans. So that says to me there is a propensity for the larger loan to prepay that is clearly signaling a scare in our community.

Mrs. KELLY. Thank you very much. Thank you, Mr. Chairman.

Chairman TALENT. I am going to have to go. I want to just ask one question and then recognize Mr. Davis. Discuss a little bit, Mr. Giegel, the agency's concerns about giving CDCs the ability to veto SBA asset sales, please.

Mr. GIEGEL. Thank you. Well, CDCs I think are very cognizant about losing money as well as a 7(a) lender might be who can now exercise that prior consent. We are asking really for no more than a 7(a) lender capability of being able to look at the overall situation and indeed a CDC certainly doesn't want to lose any money but if they perceive that recovery might be worked out in a different manner other than an asset sale, we would certainly like the opportunity to work that out, and this is no more than what a 7(a) lender would have the authority to do.

Chairman TALENT. Fred, you want to be able to respond? It sounded like this was the proposal that you objected the most strongly to. Is that a fair statement?

Mr. HOCHBERG. That is a fair statement. My understanding, and I am going to have my staff correct me if I am wrong, my understanding is that 7(a) lenders can simply not agree to participate, but they can cherry pick and decide which loans they will let be sold and not be sold.

Ms. BUTLER. Actually it is slightly different than that. At this point in time under the contract with which 7(a) lenders operate with SBA, they can refuse to allow a loan to be sold at an asset sale. However, we are revising that contract, and under the terms of the new contract the lender could refuse to have its portion of the loan sold, but it could not refuse to have the loan sold at all. SBA could still sell its portion.

Chairman TALENT. So their rights are not statutory at this point. They are under a contract with the agency.

Ms. BUTLER. That is exactly correct.

Chairman TALENT. Well, it does sound like at least you would be open to some kind of proposal, administrative or statutory, requir-

ing a consultation or something like that. That sounds like something the agency would be more open to.

Mr. HOCHBERG. Our overriding objective is to continue asset sales so we can focus our resources on helping small businesses and not be involved in the liquidating and servicing of loans. That is the direction that Congress and the Administration have set for SBA. We are just trying to keep moving in that direction as best we can, but of course we will look at any alternatives to improve it.

Chairman TALENT. Do you want the last word, Mr. Giegel?

Mr. GIEGEL. Well, we are all prudent lenders, I think here, and an asset sale we regard as absolutely the last resort. I think we can all be reasonable here if that is what we perceive if that is the best solution we can agree to that. But we obviously would like to say in certain instances that more standard recovery might be a better solution.

Chairman TALENT. Well, I haven't conferred with the ranking member on it, but my initial reaction is, if the agency feels that strongly about it, maybe we ought not to give you an absolute veto but perhaps some requirement of consultation. As you say, we all are out for the same thing. So if we have some kind of regular working procedure, I would think we could protect your interest that way. I haven't closed my mind on it, and I haven't talked with Ms. Valezquez about it but that is my initial reaction. Okay. I will recognize Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman. Mr. Geigel, could you give me a profile of the typical 504 borrower?

Mr. GIEGEL. Well, the typical 504 borrower certainly can run the gamut of any and all small businesses out there. We have, for instance, done everything from custard stands to industrial buildings. They tend to be though entrepreneurs who have several years of activity, established a business and reached a point where they may be in leasing a building or leasing machinery, and it comes to a point where prudently they need to either make an expansion to meet an established market need, or they need to acquire some major pieces of equipment to meet this next expansion.

So, generally, these are clientele, which for a variety of reasons, don't meet traditional lender requirements particularly from the collateral point of view, but which the 504 in its second position can help the lender make a decision to make the loan. These initial loans are generally on the smaller side in these early deals. We are looking probably at debenture sizes in the $200,000 to $350,000 range, total project perhaps in the $600,000 to $700,000 range.

What is crucial though is that we have been doing this since 1981 that there are subsequent expansions. Perhaps a couple of years after that initial expansion they need additional machinery. They still don't have quite that track record, particularly on things like machinery with the heavy discounts imposed on machinery to make these types of loans. So we are often involved in second and third involvements with these small businesses as they continue to make expansions.

Mr. DAVIS. What would you consider to be the biggest problem that the program has if you had to cite a problem?

Mr. GIEGEL. It is hard to know where to begin actually but the one biggest problem, I think it is a matter of, if you will, communication to getting out to the small business community to the small business owner about the advantages of the 504 program. CDCs, whether they are local, city wide, county, multi-regional or even statewide, usually have fairly small, if you will, advertising budgets. I don't know of any CDC that takes out TV ads talking about that there is a 504.

So it is very difficult for the CDC industry to get down to individual small businesses. I mean we undertake seminars, talk with chambers and all the regular, shall we say, low cost marketing avenues, but it is still hard to reach all those small business entrepreneurs about the particular advantages of a 504 program. I think if we had that ability to better penetrate the marketplace, we would probably be back here asking for more appropriation authority to be able to meet the demand that we think is out there.

Mr. DAVIS. Thank you. Mr. Hochberg, let me first of all just express my appreciation to Administrator Alvarez through you for the strong presence that the SBA had had in the mid-West especially in the Chicago region. Any number of times, I can recall opportunities that have existed where the New Initiatives Program and other activities and Y2K and the whole business has been articulated many, many times in an effort to make sure people are in fact aware.

It seems to me that defaulted loans especially from a lender's perspective is some concern and consideration. Could you explain to us the process of selling those?

Mr. HOCHBERG. I just want to make sure I understand your question, Congressman. Our asset sales regarding 7(a) loans, is that what you mean?

Mr. DAVIS. Right.

Mr. HOCHBERG. We have a portfolio approximately in the range of $8 to $9 billion worth of loans to sell. About $1.5 billion are either old loans that were direct loans from the SBA or loans that we have taken back from the banks. The balance are disaster loans that SBA still makes on a direct basis. Our first asset sale is scheduled for August. We are hopeful that is going to go successfully, and based on the result of that sale, we expect to continue asset sales over the next few years. By selling off those assets, we will be better utilizing our people to perform more oversight work instead of the commercial work such as servicing loans.

Mr. DAVIS. Are those targeted or skewed in any particular direction? Do you try and convince any particular purchasers to buy those?

Mr. HOCHBERG. In this first sale there will be a somewhat smaller pool, so that small investors can bid if they are interested.

Mr. DAVIS. Thank you. Mr. Wilkinson, do you think that the process of recovery, the effort towards liquidation and recovery have much to do with lenders decisions whether or not to participate in these programs? I mean are they deterrents currently, are there ways that we can perhaps improve them?

Mr. WILKINSON. From a servicing and liquidation perspective in the 7(a) program things really run quite smoothly because the lender would follow SBA standard operating procedures, but they

would actually conduct the liquidation activities. So it is a standard piece of business that lenders do every day, so I would not view that as a deterrent to getting into this program. I think if anything it would be for a new lender the fear of learning all the new regulations, the standard operating procedures, but what we are finding once engaged lenders are not having much trouble with it.

Mr. DAVIS. And, finally I guess, my last question is for Ms. Faulk. Could you think of ways, we are talking about changes, to me all changes are designed to be productive, that is to make things better to increase, improve, do better than whatever it is that you are doing. How do you view the changes that we are proposing right now in terms of the overall abilities for people to make use of the SBA programs, especially the two that we have singled out?

Ms. FAULK. I see them as extremely beneficial to the small business borrower and that is our objective and that is the mission of Congress is to provide the long-term financing to the small business who has no alternative for term debt in the conventional market and I think the prepayment charges that the draft legislation is recommending is warranted and I think will be protective to the ongoing success of this program.

Mr. DAVIS. Thank you very much and I thank you, Mr. Chairman.

Mr. MANZULLO. Thank you, Mr. Davis. I am intrigued with apparently there is some dispute regarding the mission of the 7(a) program. More particularly, Ms. Faulk, you made the statement, which at first blush I would agree with, that people who got the 7(a) loans in the first place and were able to repay within a matter of a short period of time could have obtained the loans through conventional financing. Would that be a correct statement?

Ms. FAULK. In part, yes. With the liquidity in the marketplace, there was or is an alternative for a different loan for their project other than SBA financing, but the flip side to that coin is that the conventional lending community is still adverse to lending to a small business borrower. So it is easy to sit on the sidelines and let this borrower and a lender go through the credit quality approval of getting the term SBA loan, and then after the start-up is complete, offering a refinancing loan in the first three to six months that is attractive to the borrower versus his term loan in the SBA program.

Mr. MANZULLO. So maybe we need, as a prerequisite to get a 7(a) loan, that the potential borrower be turned down by conventional financing, which is the way SBA started.

Ms. FAULK. I think that was the initial mission of SBA, back in the '70s, when we were beginning that the rule was you had to be turned down by two banks before you could go—and this is when SBA was still doing some direct financing as well but early in the '70s in the inception of the secondary market that was the benchmark, that you had to be turned down by two conventional lenders before you could approach a lender and use the SBA program.

Mr. WILKINSON. If I might jump in. One of the things it did create was a very hardship for a borrower to go face a lender and get a no letter, hand it to them. The second point would be, we need to take a look at what was the number of loans that prepaid in the

first few months that we are talking about in relation to the 45,000 loans that were made last year. It is a very small, small percentage. We are not talking about a vast majority of the portfolio. We are talking about a couple handfuls of loans.

Mr. MANZULLO. What is it, 9 percent, Ms. Faulk?

Ms. FAULK. It was 9 percent just in fiscal '98 and only on the $500,000–$750,000 loan. That is not the whole universe of that. That is only the loan sold in the secondary market. We cannot even address the total picture of what was not sold in the secondary market. The statistics are not available.

Mr. MANZULLO. What bothers me is the purpose of the SBA is to extend credit to people who would otherwise have a difficult time getting credit. If there is a need for short-term credit, which there may be, I think we are making certain assumptions here. I have been in small business my entire life and banks want to see a track record. Even if it is six months, then perhaps we should be addressing some legislative changes and higher fees, maybe in the terms of prepayment penalties as you are suggesting.

But the problem I have when you talk about prepayment of penalties is that some people would be stuck with high interest rates. We had a hearing about two years ago about people who wanted to pay off their 504 loans were stuck with 18 percent interest, and then they couldn't do it. They were stuck with that, and I don't have the answer to it. In Illinois it is illegal to have a prepayment penalty on a residence. It is obviously different on a commercial enterprise, but I think we ought to be taking a look at examining where the need is in the market. And if there is a need for short-term financing, some interim financing until a start-up company as you say can show a record, then the interest rate should be perhaps even higher than the conventional market.

Ms. FAULK. We have suggested to the SBA as an alternative a possible short-term program and we would clearly promote with Congress that if you wanted to cut out a certain portion of the allocated dollars for this particular interim financing to prohibit the misuse of those who really need the term debt and we would advocate it.

Mr. MANZULLO. When you use the word misuse, what you are saying is that potential borrowers are simply looking at the SBA loan as one of a series of things that they could do to get start-up capital, even if they planned somewhere down the line, at the time they are signing the document to get the SBA loan, they are really going to take out another loan in three to six months. I just think we need to do some work on that, because if we are not serving a need in the community that is not being fulfilled then we have to question our existence.

I have a question here for Mr. Wilkinson. In your testimony you recommend a floor subsidy rate of 1.25 percent. If the subsidy rate drops below that then fees to borrowers are reduced, I would like to see a zero subsidy rate for the 7(a) program because then Congress would not have to appropriate money for the program. What do you think about this?

Mr. WILKINSON. Well, one of the purposes of our recommending a subsidy rate floor was to get into the whole discussion of what is the role of government in this program. What kind of congres-

sional support are we going to get? There is nothing magical about a 1.25 percent, maybe it is 1 percent, but we have a fear based on the gyrations we have seen coming out of the OMB subsidy model, that in one year we could get a big spike in the subsidy rate estimate that would require huge fees. And if we had not been on the appropriation radar screen, it is going to be tough to get money for what would appear to be a new program even though it has been around for many, many years.

So we are reluctant to move to a zero subsidy rate. That said, it appears that looking through the re-estimates in the subsidy model from '96, '97 and '98, we are on our way to in fact having been at a zero subsidy rate and the money is flowing through to the benefit of the Treasury, so that borrowers are actually paying fees higher than they would have to today that based on the re-estimates we probably were already at a zero subsidy rate, but the money is coming out of borrower's pockets and flowing to Treasury.

Mr. MANZULLO. Ms. Tubbs Jones.

Ms. TUBBS JONES. Actually I will give my time to Ms. Napolitano who has been here longer than I have, so I will yield to her.

Mr. MANZULLO. Ms. Napolitano.

Ms. NAPOLITANO. Thank you, Mr. Chair. There are several issues that, as I was listening to your testimony, have kind of rattled around in my head in regard to women-owned business loans. And, specifically to Mr. Hochberg, what outreach or how can you quantify loans that have been made to women-owned businesses? We discussed veteran-owned businesses. Right now my concern is women-owned businesses specifically because in California we have a large—we heard today it is an increasing segment of the business population, women-owned business. How are we providing the attractiveness to assist a lot of the new entrepreneurships?

Mr. HOCHBERG. Thank you for asking that question. We track our loans to women-owned businesses, as we track our loans to minorities and veterans, on a weekly basis.

Ms. NAPOLITANO. By area or by——

Mr. HOCHBERG. We track it nationally and we also can track it by congressional districts. Our outreach efforts are supported through our Women's Business Centers. They offer hands-on counseling on how to write a business plan, how to acquire more economic literacy, and other basics. We also use our Microloan program as a way of helping startups and home-based businesses.

Ms. NAPOLITANO. Only through your women SBDCs?

Mr. HOCHBERG. Through the Women Business Centers, and the Small Business Development Centers (SBDCs). In addition, we have signed over 80 agreements with organizations around the country, such as national organizations of business owners, Hispanic Chamber of Commerce, the African American chamber of commerce, to try and make sure that their membership is fully aware of the programs and services we have available.

Ms. NAPOLITANO. I have a reason for asking, because I have gotten some of the statistics from SBA in regard to the centers in the area and those that do outreach to small business. I have one in my area. And I am concerned because we don't seem to be putting an emphasis on that particular segment of business. And I don't know what your statistics may show in regard to the default statis-

tics on women-owned business, whether or not it is working out, whether or not they need assistance. Where does that lead to? Are they being successful? Are we assisting them to achieving the goals of becoming the new entrepreneurs that are going to be in business ten years from now.

In the end I am looking for the jobs that they are providing. That said, I need to know how much is actually being focused on women and women-owned business systems.

Mr. HOCHBERG. We just authorized grants to fund another 24 Women's Business Centers this month so that will certainly help increase the number we have across the country.

Ms. NAPOLITANO. Okay. But are you targeting them to specific areas where the greatest need may be found, and if so how are you looking at that targeting?

Mr. HOCHBERG. I would encourage any organizations within your district to apply. We would like to look at them when we open the program up again for grants next year. We are always looking to expand this outreach and to find more intermediaries to help us in this area. One of the things we also want to do is to make much clearer the connection between our loan products and micro-lending, so that it is not just handholding, but it is really helping them start and grow a business.

Ms. NAPOLITANO. That was one of my questions. The second one, we keep talking about the debt that SBA has not recovered. You mentioned a figure of the current funding that we are now being shorted because it has not been repaid. How much was that amount?

Mr. HOCHBERG. I am not sure I understand the question.

Ms. NAPOLITANO. Well, how much debt is out there that has been defaulted?

Mr. HOCHBERG. I referred to about $8 to $9 billion in debt that we hold. That is not all defaulted debt.

Ms. NAPOLITANO. I am looking at what is the default amount.

Mr. HOCHBERG. Let me check.

Ms. BUTLER. We will have to get back to you.

Mr. HOCHBERG. Yes, I have to get back to you with that amount.

Ms. NAPOLITANO. Can you give me a ballpark figure?

Ms. BUTLER. It is a very small percentage over time. It is less than 10 percent.

Ms. NAPOLITANO. Okay. Then possibly you have a recovery rate, even though it may be slow in coming back. Is that correct?

Ms. BUTLER. That is correct.

Ms. NAPOLITANO. Okay. You are willing to sell a portion of that or some of it, right?

Mr. HOCHBERG. Yes.

Ms. NAPOLITANO. And which portion is this that you are willing to sell? I am trying to figure out which is the one that pays you back on a regular basis even though it is late, well, some of it may be late, and which one is really defaulted that you are going to have collectors go after them.

Mr. HOCHBERG. Our asset sales program includes both those who are paying us back on time and those who are not.

Ms. NAPOLITANO. Okay. That explains it. Okay.

Mr. HOCHBERG. It includes both. I should add, interestingly, as we have talked to the borrowers about perhaps selling their loans, many of them have immediately become current or paid the entire loan off.

Ms. NAPOLITANO. Okay. Then the other question has to do with the—okay, so much for that.

Mr. MANZULLO. I would like to go to Ms. Jones Tubbs, at this point, so we can get in at least five minutes on her part.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Thanks, Gracie. For the record, that is Congresswoman Napolitano. I am going to try to make my questions kind of short. I have one for each of you. Ms. Faulk, do you have any other proposals to address the prepayment issue whether or not loans are increased?

Ms. FAULK. Well, again, proposals——

Ms. TUBBS JONES. That we haven't given you the opportunity to speak to.

Ms. FAULK. No, ma'am. We have made a similar recommendation back in September to the Oversight Committee as an alternative for the short-term borrowing abuse that SBA considered creating as a short-term financing program.

Ms. TUBBS JONES. Okay. Thank you very much. Good morning, Mr. Hochberg. How are you, sir?

Mr. HOCHBERG. Good. Good to see you.

Ms. TUBBS JONES. I want to, for the record, express my thanks for the support the SBA has given me as I have worked my way through learning what it means to be a member of the Small Business Committee and the attendance at our event in Cleveland, however long ago it was. I am losing track of days. But I have one particular question I would like to ask. In your statement you say that we rely on the credit decisions of our lending partners for about 75 percent of our loan approvals.

We place greater reliance on the experience and expertise of its lending partners to perform. Do you have any information that would distinguish between what types of loans you are giving now under that setup as compared to the loans that were being administered or given out when SBA was responsible for this process, and you don't have to give that to me today, but if you could give me some comparisons down the line I would like to have it.

And I also would like to know has it changed the face of the borrower, meaning are there more minority loans, less minority loans, more women's loans, less women's loans, anything that you could tell me the impact this had. I am just curious as to whether or not it may be a good practice and then maybe it may be something we need to assess one way or another. So that was my question for you.

For you, Mr.—let me get your name correct. I am sorry. Mr. Wilkinson, you stated that you need a better way of penetrating the 504 market in order to let people know what is available under that program. Is that correct?

Mr. WILKINSON. That is one of—a major problem, yes.

Ms. TUBBS JONES. It is a major problem. Can you tell me who are the members of your group that exist in the 11 congressional districts of Ohio? You don't have to give them to me today but I would like to have them because I would like to assist them in my

district in getting information out about 504 opportunities. And I would suggest that you might make use of other members of Congress that are on SBA committee to help you do that.

And it is not—so it is real clear for the record, it is not for political purposes. It is in our best interest to have small businesses in our districts to do a good job, and if there are programs available to them, then we need to get on the stick and do what we need to do to let those programs be known about. So do you want to get that for me, please? Thank you.

My last question, Mr. Geigel, in Mr. Hochberg's statement he references a statement by Federal Reserve Chairman Alan Greenspan as follows. Some of the studies have found discrepancies in the turn-down rates by minority-owned small business applicants and that not all of the cited differences could be readily explained by income, balance sheet factors or credit history.

To the extent that market participants discriminate consciously or more likely unconsciously credit does not flow to its most profitable uses and the distribution of output is distorted. In the end costs are higher, thus real output is produced and national wealth accumulation is slowed. By removing the noneconomic distortions that arise as a result of discrimination we can generate higher returns to human capital and other productive resources, and it goes on and on and on with that.

But my question to you representing the National Association of Government Guaranteed Lenders, what is it that you are willing to do or your group is willing to do to assure that the loans—that you are more responsible for now than ever that SBA has given that responsibility to you go to women and minority-owned businesses when you can't even—sometimes it is not even documented.

Mr. WILKINSON. Sure. I would be happy to answer that. First of all, Mr. Hockberg started off I believe earlier today with the number that SBA has 19 percent fewer employees today than they had in 1992. At the same point in time, the program has grown fourfold, so for the agency to be able to get the money in the hands of small businesses, they had to rely on the private sector.

Ms. TUBBS JONES. Understood. I don't have any question about that.

Mr. WILKINSON. I am just trying to answer part of his question. Now what we have done over the last year with the agency, we have entered into a memorandum of agreement. We are engaging in training exercises all over the country on lending to new markets. We have—Mr. Davis will enjoy this. We have Dick Turner from South Shore Bank in Chicago was our lead instructor who helped us put the class together.

We are doing 25 lender sites. We are also doing ten intermediary sites where SBA is our co-sponsor, and those are underway and the last few have been very well attended. So beyond that we are willing to sit down and look at a whole host of possibilities. One of the things we have tossed out is perhaps on smaller loans we can go back to a 90 percent guarantee. We don't think that would cost very much on a subsidy front and would be an incentive to get down into the $150,000 and less loans. Beyond that, again, we are willing to sit down and talk as to what we can do to make this work.

Ms. TUBBS JONES. A quick follow-up, Mr. Chairman, I am hosting a small business seminar in my community on September 24 of this year. Could you let me know who the people are in your organization in the 11 congressional districts in Ohio, so I can call upon them to participate in that workshop. Thank you, Mr. Chairman.

Mr. MANZULLO. Thank you. We thank you for coming to us this morning. We got everybody's questions in, and hopefully everything answered. We have to go and vote. This committee is now adjourned.

[Whereupon, at 11:55 p.m., the committee was adjourned.]

STATEMENT OF
CHAIRMAN JAMES M. TALENT
COMMITTEE ON SMALL BUSINESS
HEARING ON
PROPOSED AMENDMENTS TO THE 7(a) AND 504 LOAN PROGRAMS
JUNE 24, 1999

Good morning Ladies and Gentlemen, and welcome. Thank you for joining me this morning to examine proposed changes to the 7(a) and 504 loan programs. I am certain that by working together we can make these vital programs more responsive to the needs of small businesses and lenders alike.

The proposed changes to the 7(a) program merit a brief description. It is suggested that the maximum guarantee amount of a 7(a) loan be increased to $1 million from the 1988 limit of $750,000 in order to keep pace with inflation. A parallel proposal exists for the 504 program. Another proposal suggests the removal of the provision which reduced SBA's liability for accrued interest on defaulted loans since the provision's intended savings provision have failed to materialize.

The 7(a) program is now facing the problem of early repayment of large loans, which is jeopardizing the subsidy rate. The proposal before this Committee seeks to remedy this problem by assessing a fee to the borrower for prepayment within the first 5 years of a loan with a term in excess of 15 years. Another proposal seeks to stabilize the subsidy rate for the 7(a) program at 1.25% by requiring the Administrator to adjust program fees. This is similar to the current stabilization process for the 504 program. I am especially interested in hearing our witnesses comment on these two proposals.

Also there is a proposal to modify 7(a) rules which prohibit loans for passive investment. When we last reauthorized the 504 program we modified a similar restriction in order to permit the financing of projects where less than 20% of a space will be rented out when the small business in question will occupy the remaining space. We need to discuss providing similar options to 7(a) borrowers.

Allow me to also briefly describe the proposed changes to the 504 program. It is suggested that the maximum debenture size for public policy debentures be increased from $1,000,000 to $1,300,000 and that women owned businesses be added to the categories qualifying for thes debentures.

Currently, the 504 program levies fees on the borrower, CDC , and the participating bank. The bank pays a one time fee whereas the borrower and CDC pay a percentage of the outstanding balance annually in order to provide operational funding for the 504 program. These fees sunset on October 1, 2000 and it is proposed that we continue them though October 1, 2003.

Additionally, it is suggested that we grant permanent status to the Preferred Certified Lender Program, which will otherwise terminate at the end of fiscal year 2000.

Finally, to address the problem of low recovery rates on defaulting 504 loans, it is proposed that a permanent program be created to handle the liquidation of those loans. This would replace a pilot program created in 1997, and gives qualified and experienced CDCs the authority to handle the liquidation of loans with the approval of the SBA.

I am pleased to welcome Tony Wilkinson from the National Association of Government Guaranteed Lenders, Donna Faulk, a Vice President at Prudential Securities, who today represents the Bond Market Association, and John Giegel from the Wisconsin Business Development Finance Corporation, representing the Certified Development Companies. Together with the testimony offered by SBA Deputy Administrator Fred Hochberg, who we are always pleased to see, I am certain that their testimony will provide us all with a better understanding of the proposed amendments to the 504 and 7(a) and the needs of the small businesses and lenders they assist. Thank you all for being here.

I now turn to my distinguished colleague, Ms. Velazquez, for any opening comments she would like to make.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

STATEMENT OF

FRED P. HOCHBERG
DEPUTY ADMINISTRATOR
U.S. SMALL BUSINESS ADMINISTRATION

SBA'S 7(a) & 504 PROGRAMS

BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

June 24, 1999

Federal Recycling Program Printed on Recycled Paper

Mr. Chairman and Members of the Committee, thank you for inviting me here today. In my testimony I will discuss some of the exciting new initiatives underway at the U.S. Small Business Administration (SBA), including our on-going modernization and lender oversight programs as well as the Agency's New Markets initiatives. I will also be happy to present the SBA position on the legislative proposals now being considered by this Committee.

In 1953, the Congress created SBA to aid, counsel, assist and protect the interests of small business concerns. The clear legislative intent for SBA's capital programs was that they fill gaps left by the commercial marketplace. SBA takes this responsibility very seriously.

Based on comments that we have received from small businesses, SBA strongly believes that obtaining access to capital continues to be one of the most critical challenges facing small businesses today. SBA's concern over this important issue is reflected in the fact that two of our Government Performance Results Act goals are tied directly to the capital programs – increasing access to capital and making SBA a leading edge financial institution.

Over the past several years SBA has made major strides towards the achievement of these important goals. The current budget environment makes it especially important that the Agency operate in the most efficient and cost-effective manner possible. To do this, SBA must offer programs and processes

that are easy for our lenders and other partners to use, thus allowing us to take advantage of their unique skills and abilities. And, in this effort, we must also make sure that our programs are appropriate to meet the widest spectrum of small business borrowing and investment needs.

Modernization and Lender Oversight

We know to be effective in meeting our legislative mandate, we must continue to modernize. In its 7(a) and 504 programs, SBA is now delegating greater authority to its lending partners than ever before. Today, with 19 percent fewer employees than in 1992, we rely on the credit decisions of our lending partners for about 75 percent of our loan approvals. The total SBA portfolio now contains almost 500,000 loans worth just under $40 billion, nearly double what it was just seven years ago, when it consisted of around 261,000 loans worth just over $20 billion.

For the first approximately 40 years of the 7(a) program's operations, SBA assured appropriate program oversight on a loan-by-loan basis. Originally this was accomplished by directly financing each loan request after a careful review by a SBA loan officer, and, more recently, by providing a hands-on review by SBA of every application submitted by a commercial lender seeking SBA's guaranty. Over the past few years, however, SBA has transformed its operations from a hands-on delivery system to one in which SBA places greater reliance on the experience and

expertise of its lending partners to perform the day-to-day tasks related to loan underwriting, disbursement, servicing and any necessary liquidation.

SBA has made similar changes in the 504 program. In 1997 SBA established a preferred lenders pilot program for Certified Development Companies (CDCs) known as the Premier Certified Lender Program (PCLP). Under PCLP, participating CDCs are authorized to approve, close, service, liquidate and litigate 504 program loans. SBA has also implemented its legislative authority to conduct a pilot program allowing qualified CDCs to liquidate their SBA 504 loans subject to SBA's review and approval of the CDCs' liquidation plans. Twenty CDCs now participate in this pilot which began in June 1997. In accordance with its authorizing legislation, this summer SBA will evaluate the success of this pilot, and will provide a report to Congress by September 30, 1999.

While the role that SBA plays in handling individual credits is decreasing, its role in conducting appropriate lender and loan program monitoring is increasing. Today, one of the Agency's most important goals is to provide proper incentives to assure that capital is available to creditworthy small businesses, while at the same time protecting the interests of the American taxpayer by efficiently managing program risks.

To assist in the attainment of this goal, SBA's FY 2000 budget request includes $8 million to continue the systems modernization efforts SBA began in FY

1998. When this multi-year project is completed, we expect that our new system will enable us to better identify and manage portfolio risk. It also will allow us to integrate SBA's system with those of private sector lenders. Included is critical funding to carry out the staff training that goes along with the modernized systems.

As part of its on-going modernization efforts, SBA has implemented two new lender oversight systems for reviewing special classes of 7(a) lenders. Last Fall the Agency entered into an agreement with the Farm Credit Administration (FCA) under which FCA agreed to assist SBA with its examination of the 14 non-depository, non-regulated institutions that are authorized to make SBA-guaranteed loans. Prior to the establishment of this new process, these lenders, known as Small Business Lending Companies (SBLCs), had not been examined on a regular, consistent basis. I am pleased to tell you that FCA and SBA have completed the on-site portion of all 14 examinations, and are now working together to finalize the individual institution reports, as well as to prepare a summary of the overall examination project. In order to assure continued safety and soundness in the 7(a) program, SBA will continue its regular examination of these institutions.

SBA has also taken steps to assure that its Preferred Lenders Program (PLP) lenders are examined on a regular, consistent basis. In 1997, SBA established a Lender Review Branch in Kansas City, MO and in March 1998, SBA implemented its PLP review program. To assist in this effort, SBA entered into a contract with a

private sector firm, Cobb, Bazillio and Thompson, Inc. Contractor personnel help SBA review staff gather data to assess how well individual PLP lenders comply with SBA PLP program requirements. The first round of PLP reviews was concluded in March 1999, and SBA began its second round of reviews in April. As part of overall lender oversight program, this review effort will be on going.

To further protect America's investment in small business and the Agency's public trust, SBA also has:

- Established a Risk Management Committee to assess loan risks and to design strategies for assuring program soundness;
- Designed a new database for evaluating the portfolio performance characteristics for each Certified Development Company;
- Designed a laptop computer-compatible lender oversight system for reviewing non-SBLC, non-PLP lenders for program compliance;
- Implemented regulations to govern the securitization, or sale, of the unguaranteed portions of 7(a) loans; and,
- Begun implementing a carefully conceived asset sales program through which we will sell the Agency's portfolio of direct and purchased loans.

SBA is well aware that the successful implementation of its modernization and oversight efforts is key to SBA's ability to continue meeting the special credit needs of small businesses, especially those that are most in need of the Agency's assistance –the newest and smallest entities in the small business community.

Targeting Newer, Smaller Businesses

As I have indicated, one of the most difficult challenges that SBA has faced over the past several years is discovering how to make its capital programs responsive to the widely diverse needs of both the small business community and SBA's lending partners. One way SBA has attempted to address this challenge is by making available the broadest range of equity vehicles and loan products and services. With this in mind, over the past several years SBA has introduced a number of new or revamped variations in our loan and equity programs -- what we think of as SBA's continuum of services.

The SBA product line begins with the Microloan program through which SBA funds are used to provide very small loans, up to $25,000, and technical assistance to the smallest small businesses. The microloan program often provides a small business with its first access to credit. And, it can act as a feeder -- helping small businesses move from non-traditional, community-based financing to the commercial marketplace.

The microloan program was made permanent just last year. Since that time, SBA has been working to identify ways to make the program more accessible to the intermediaries that deliver microloans and technical assistance. Our ultimate goal is to have a national microintermediary network that is available to every small business, regardless of its location. To make sure that we have the widest possible

geographical coverage, we are now actively recruiting additional microintermediaries. We appreciate the help that you have already given us with this expansion effort, and we look forward to your continued assistance.

The 7(a) program, which currently authorizes SBA to guaranty up to $750,000 for a small business to meet virtually any of its business needs, is the second program in SBA's continuum of services. Under this program, SBA offers a wide variety of loan products and loan processes designed to give borrowers and lenders maximum accessibility and flexibility. Last fall, for example, we rolled out major changes to the highly successful 7(a) low documentation (LowDoc) and SBAExpress products. In both cases, we increased the maximum eligible loan size from $100,000 to $150,000 and made other changes designed to make the programs more user-friendly for both lenders and borrowers. In redesigning LowDoc and SBAExpress, our intent was to increase the availability of smaller size loans. These redesigned programs are helping to provide increased access to smaller loans, but they are not the total solution.

Just last month, we announced another new pilot proposed to SBA by the National Community Reinvestment Coalition, a trade association representing community-oriented lenders. This pilot, Community Express, follows the lead of the SBAExpress program by allowing participating lenders to use their own forms and documents to make loans up to $250,000 in specified target geographical areas. However, Community Express has two additional features that distinguish it

from the SBAExpress program. First, lenders may receive the full SBA guaranty for Community Express loans (either 75 or 80 percent depending on the size of the loan). In addition, in exchange for the special benefits provided by SBA, lenders will provide technical assistance to accompany the loans. SBA is also continuing to look at other ways to improve or streamline our 7(a) program to make it more accessible for both borrowers and lenders.

The third program on SBA's continuum of services is the Certified Development Company Program, more commonly known as the 504 program. Under this program SBA provides access to long-term financing for fixed asset acquisition.

The 504 program is a good example of financing through a public-private partnership. In a typical 504 program transaction, a project is funded from three sources. The borrower provides a minimum of 10 percent of the total project costs, a commercial lender provides a minimum of 50 percent, and SBA guarantees a debenture, which provides the remaining up to 40 percent of the project financing. The SBA guaranteed debt can be repaid over a term of either 10 or 20 years. Working with the industry, over the past few years, SBA has significantly re-engineered 504 processes to make them more efficient.

In accordance with relatively new legislative authorities, SBA has also implemented a pilot preferred lenders program for Certified Development

Companies (CDCs), the Premier Certified Lenders Program, as well as a pilot to test the efficiency of authorizing qualified CDCs to liquidate their own loans. Both of these pilot initiatives are addressed in the proposed legislative changes under consideration here today.

The next program in SBA's continuum of services is the Small Business Investment Company (SBIC) Program. This program helps small businesses that need more patient capital than is available to them through SBA's loan programs. By its design it provides small businesses access to smaller sized capital investments than are available in the commercial marketplace. This program helps to fill the capital gap for a small business when a loan will not meet the business' growth needs and the amount of the equity investment required is smaller than what is typically available in the investment community.

Looking particularly at SBA's loan programs, it is clear that the Agency needs to constantly seek new ways to make it faster and easier for small businesses to gain access to capital. But, our work is ever-changing and ever-challenging. Small businesses, particularly newly established companies, tell us the credit that continues to be the most difficult to get, is credit and working capital in small amounts, typically up to $150,000.

Changes in the commercial lending industry, including the large number of bank consolidations, the move to centralized processing, greater use of credit

scoring and other changes in the marketplace, contribute to this small loan access problem. Added to these challenges is the fact that it typically requires the same level of effort and the same administrative expenditure for a lender to approve a very small loan as it does for the lender to approve a much larger loan. But, the lender's return on its investment is much less for the small loan than it is for a larger loan. This factor, alone, can act as a major disincentive for a lender to provide a large volume of small loans.

SBA's 7(a) program data supports the conclusion that smaller loans are becoming increasingly difficult to get. The average SBA guaranteed loan approved this fiscal year is around $228,000, up from $213,000 just last year. Concern over this issue makes it especially important that SBA take special care to assure that the smaller loans, most critically needed by the smallest businesses and those that are just starting out, remain available.

Legislative Changes Proposed by SBA

In SBA's FY 2000 budget we requested several changes designed to further encourage loans under $150,000. Our proposal would cut the guaranty fee from 3 percent to 2 percent for loans between $100,000 and $150,000, saving small businesses up to $1,000 on each loan. It would also reduce the on-going fee for lenders on all loans up to $150,000 from 50 basis points to 30 basis points (.05 to.03 percent). This change would save small business lenders approximately

$300 during the first year of a loan, thus providing a greater incentive for lenders to make the loans. For non-SBAExpress loans, the proposal also would increase the maximum guaranty percentage for loans between $ 100,000 and $150,000 from 75 to 80 percent. The guaranty percentage for SBA Express loans would remain at 50 percent and the guaranty fee for Export Working Capital loans would remain at 90 percent.

The New Markets Initiative

Since President Clinton took office, the economy has created more than 18 million new jobs. Yet even during the greatest peacetime expansion in American history, some areas have been left behind.

At the Federal Reserve System Research Conference on Business Access to Capital and Credit held in March, several papers were presented on the issue of apparent disparities in the access to credit for minority-owned businesses. In his speech at the conference, Federal Reserve Chairman Alan Greenspan noted that some of the studies had found discrepancies in the turn-down rates for minority-owned small business applicants, and that not all of the cited differences could be readily explained by income, balance sheet factors, or credit histories. He indicated that more work needs to be done to identify any other factors that could account for these outcomes. But, he accurately captured the challenge that we face in this Nation as public providers of credit when he noted that:

To the extent that market participants discriminate – consciously or, more likely, unconsciously – credit does not flow to its most profitable uses and the distribution of output is distorted. In the end, costs are higher, less real output is produced, and national wealth accumulation is slowed. By removing the non-economic distortions that arise as a result of discrimination, we can generate higher returns to human capital and other productive resources. It is important for lenders to understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions and, ultimately, robs the broader economy of growth potential.

Chairman Greenspan concluded this portion of his comments by stating that, as part of the solution to this circumstance, "...we need to make further progress in establishing business relationships between the financial services sector and the rapidly growing number of minority- and women-owned businesses." SBA fully embraces this concept.

As part of the Administration's plan to make sure that all Americans have access to the resources required to turn their entrepreneurial dreams into reality, in his FY 2000 budget, the President announced a New Markets Initiative. This initiative is a sweeping new public/private partnership designed to boost business opportunities and to meet the unmet needs of small businesses.

For SBA, the creation of this government-wide initiative supports and builds on efforts that the Agency has undertaken over the past several years to provide better support to assist New Markets small businesses. As part of these efforts, SBA has been working to strengthen its relationships with both national and local organizations that provide access and assistance to New Markets small businesses. Since 1998, we have entered into more than 80 agreements with these organizations designed to assure that New Markets businesses have access to a variety of support sources.

One of SBA's proposed new initiatives to assist New Markets is a very limited New Markets Lending Company (NMLC) pilot program. Under this pilot, SBA will approve a small group of lenders to provide loans specifically targeted to the New Markets small business segment. In our loan programs, the term New Markets small businesses includes those that are located in, or locating to Low and Moderate Income urban and rural areas as well as small businesses that are owned by minorities, women and veterans. SBA believes that the New Markets Lending Company program is necessary because the commercial marketplace still is not able to offer New Markets small businesses full access to capital and credit.

While we appreciate the efforts that our existing 7(a) lenders have made to meet the capital needs of New Markets small businesses, Agency statistics for the program for FY 98 support the conclusion that much more remains to be done. In 1997 there were 136.3 million Americans in our civilian labor force, the group most

likely to own or start small businesses. Included in this labor force were 15.5 million African-Americans and 13.8 million Hispanics. Yet, during FY 1998, only 1,834 7(a) loans were made to African American-owned small businesses and only 3,030 loans were made to Hispanic-owned small businesses. Together, these loans represented only approximately 11 percent of the 42,268 total 7(a) loan approvals - 11 percent of our loans to groups representing 21.5 percent of the country's civilian work force! These numbers clearly illustrate that not all segments of the American population participate equally in small business financing. The Agency strongly believes that when it comes to gaining access to small business ownership, the lack of access to capital should not be the barrier that causes a member of any group of to be left out.

We must find a way to give New Markets individuals the opportunity to start and grow their small businesses. The low loan approval numbers that we have cited cause us to conclude that, in order to adequately address the credit needs of New Markets small businesses, we need to look at creative, new ways of providing loan access. The NMLC pilot is designed to assist the New Markets community by giving it access to an alternate source of funding, a small group of lenders specifically authorized to provide loans focused to the special needs of New Markets borrowers.

SBA intends to select up to 20 lenders to participate in this pilot based on their proposals for meeting the special financing needs of New Markets small

businesses. We expect that the applications will include proposals for combining loans with targeted technical assistance. We also anticipate that many of the lenders seeking to participate in this program will be community-based organizations that will identify specific geographical markets in which they will use their 7(a) loan guaranty authority.

The NMLC pilot participants will be selected competitively based on their operational soundness and their commitment to servicing New Markets as demonstrated by the business plan proposals they submit. SBA will publish its NMLC selection criteria soon, and expects to approve candidates and implement the pilot early in fiscal year 2000 after we give appropriate notice to the Congress.

The Agency is already working to establish operational requirements to assure that this small pilot maintains the high standard of integrity now present in the 7(a) program. Key among these will be the establishment of minimum capital requirements and annual reporting compliance and examination requirements. With appropriate safeguards in place, we believe that this pilot will offer a unique vehicle to test alternate ways to assist New Markets small businesses.

But, SBA knows that increased access to loans is not the sole solution to meeting the capital needs of small businesses. Depending on its stage of development, the purpose for which the funds are needed, and other factors, many small businesses may find that a loan is not the appropriate answer. In many

circumstances, small businesses need more patient capital available to them only in the form of an equity injection. A recent study by SBA's Office of Advocacy estimates that each year 50,000 small firms need start-up equity financing. In 1996, SBICs and private venture firms together invested in only about 3,500 firms. This means that assistance was available to only a very small segment of the much larger pool of firms needing assistance.

Once again quoting Federal Reserve Chairman Alan Greenspan:

"I would emphasize that credit alone is not the answer. Businesses must have equity capital before they are considered viable candidates for debt financing. Equity acts as a buffer against the vagaries of the marketplace and is a sign of the creditworthiness of a business enterprise. The more opaque the business operations, or the newer the firm, the greater the importance of the equity base."

As you well know, this problem is particularly acute in economically distressed areas from rural Main Streets to our inner cities where perceived risks overshadow the real opportunities that exist there.

To address this problem, SBA's FY 2000 budget included several proposals developed in consultation with venture capital experts, to make it more attractive

for Small Business Investment Companies (SBICs) and Specialized SBICs to invest in distressed rural and urban areas.

The first proposal is to create a special form of financing called an LMI debenture, which encourages new and existing SBICs to invest in venture capital opportunities in LMI areas. The new tool allows SBICs to defer interest payments on LMI debentures for five years. This deferral enables them to lower debt service and profitability requirements for the companies in which they invest.

To qualify, investments must be in small businesses that are located in LMI areas, or that hire at least 35 percent of their workforce from residents of LMI areas. LMI areas will include HUBZones, Empowerment Zones, Enterprise Communities and counties with persistent poverty.

The second proposal is to assist in the creation of 10 to 20 New Market Venture Capital (NMVC) Companies that will focus on investments in the range of $50,000 to $300,000. Modeled on the existing SBIC program, which typically supports investments between $300,000 and $5 million, NMVCs will be a new and separate venture capital network. The program will offer a combination of equity financing and specialized technical assistance in LMI areas. This specialized technical assistance is one of the chief innovations of the program. We will be supporting hands-on accountable professional assistance through the NMVC

managers. These managers have their own money at risk, they are paid out only by helping the companies they invest in grow and prosper.

I appreciate having had the opportunity to share this background on SBA's capital programs, and on the Agency's New Markets initiatives. I would now like to provide some comments on the proposed legislative changes to the 7(a) and 504 program.

SBA is very interested in the proposed legislative changes to the 7(a) and 504 programs. As I have indicated throughout my testimony, SBA's primary concern is making capital available to all small businesses, especially those businesses that are just starting and those businesses that are still very small in size which have the most difficult time obtaining credit. This is the segment of small business lending where we see the largest gap in the commercial marketplace. We are concerned that the legislative proposals being discussed today appear to be directed towards the businesses and the loans at the larger end of the eligible spectrum.

7(a) Legislative Proposals

First, it has been proposed that the maximum amount of a loan that SBA can guarantee be raised from its current $750,000 limit to $1,000,000. Coupled with this change would be the establishment, for the first time, of a maximum loan size cap of $2,000,000. As you are aware, under current legislation, SBA can

guarantee no more than $750,000 of a loan, but there is no legislative limit on the total loan amount.

The proposed change would serve to increase the availability of 7(a) guaranteed loans for those businesses with larger credit needs. We know, however, that many of the entrepreneurs who continue to have the most difficulty in accessing capital are those with the smallest borrowing needs.

Therefore, we feel that it is critical that consideration of any increase in loan size be coupled with the incentives we have proposed to encourage lenders to increase the availability of funds for smaller loans. Furthermore, SBA believes that it is important for us to assess the possible adverse impact that the proposed increase would have on the availability of 7(a) program authority for FY 1999 and FY 2000. SBA continues to support the President's FY 2000 budget, which does not take into account these proposed changes.

The second proposed legislative change to the 7(a) program is the repeal of the mandate that the interest rate be reduced by 1 percent when a lender requests that SBA honor its guaranty of a defaulted loan. This 1 percent interest rate reduction was enacted in September 1996, and was intended to reduce the costs of the 7(a) program to the taxpayer by reducing the program's subsidy rate. Unfortunately, the impact on the subsidy rate from this interest rate reduction has

been far less than anticipated, resulting in a reduction in the subsidy rate of only between 1-1/2 to 2 basis points (.015 to .02 percent).

We note, however, that the legislation does not include an effective date for this provision. It is our understanding that if the interest rate reduction is applied to loans currently outstanding, it could have a PAYGO cost. If the provision were applied only to loans approved on or after October 1, 1999, it could have an adverse subsidy rate impact for FY 2000. SBA requests that the Committee discuss this issue with OMB and SBA to determine any potential adverse impact might come from the implementation of the interest rate reduction provision.

The third 7(a) program legislative proposal would allow the establishment of a limited pre-payment penalty for loans where the original payment period was 15 years or more, and where the borrower pre-pays at least 20 percent of the loan in any one year. Under the proposal, if such "excess" prepayments were made during the first five years of the loan, the borrower would be required to pay to SBA a fee of between 5 percent and 1 percent of the amount of the excess payment based on the timing of the prepayment.

In deciding the appropriateness of instituting a prepayment penalty, SBA must balance the adverse impact that increased prepayments may have on the 7(a) program subsidy rate and the availability of small business loans against the Agency's desire to make sure that its loans are affordable for small businesses.

SBA fully understands the basis for the request for the implementation of prepayment charges. We believe, however, that if such authority is provided, it is necessary to include a provision allowing the Administrator to suspend imposition of prepayment penalties when a change in economic conditions would cause the fees to be unnecessary or unduly burdensome to small business borrowers. We also feel that the Committee, SBA and our lenders should give consideration to other options. These options could include, for example, making the fee optional for lenders, allowing the fee only on loans with fixed interest rates, or allowing the borrower to elect either a prepayment penalty or an up-front fee.

The fourth 7(a) legislative proposal is for the establishment of a subsidy rate floor of 1.25 percent. Under the proposal when the 7(a) program subsidy rate could drop below this floor, 7(a) program fees would be decreased in a prescribed order to allow borrowers and lenders to benefit from the improved program performance that would allow the subsidy rate decrease. The establishment of a subsidy rate floor would, in effect, "fix" a minimum cost for taxpayers for the 7(a) program.

After consultation with the Office of Management and Budget (OMB), SBA believes that it must object to any proposal that would legislate a subsidy rate floor. The Chief Financial Officer Act requires every Federal agency to review its fee structure every year. If continued performance warrants it, SBA looks forward to being able to consider fee adjustments on their individual merits. However, SBA

believes that any fee adjustments that are ultimately approved must be structured so that the benefits accrue first to the borrowers with the smallest loans. Under the proposal now under consideration, borrowers with loans up to $100,000 would realize no cost savings.

The last 7(a) legislative proposal would: (1) authorize SBA to allow a borrower to permanently lease out up to 20 percent of any property constructed with the proceeds of a 7(a) loan; and, (2) require the borrower to permanently occupy and use only 60 percent of the total business space in the property. This proposed change is consistent with a legislative change made to the 504 program in 1997.

SBA believes that 7(a) and 504 program criteria should be consistent where appropriate, and that, in this case, consistency is appropriate. We would note, however, that the desired outcome could be accomplished by a regulatory change rather than by statute.

504 Legislative Proposals

The first 504 legislative proposal includes a provision, similar to the 7(a) program proposal to increase the maximum sizes of the debentures that SBA can guarantee. The maximum would be increased from $750,000 TO $1 million for projects that do not meet one of the legislative public policy goals, and from $1

million to $1.3 million for projects that meet one of the goals. SBA believes that it may be appropriate to support this change. However, we must carefully analyze the impact that the change could have on current program fees based on data relating to the performance of larger sized 504 loans.

The second 504 legislative change proposed is to include women-owned business development as one of the 504 program policy goals that allows larger debentures. SBA believes that this change is in keeping with the spirit of the program's public policy goals, and thus supports it. However, as we testified yesterday before this Committee, we believe that it is also in the best interest of small business to include veteran-owned business development among the list of the program's public policy goals. We therefore recommend that the proposed legislation be amended to include both women- and veteran-owned businesses on the list of public policy goals.

The third legislative proposal for the 504 program is to extend the sunset date of the 504 guaranty fee and the one-time third party lender fee from its current September 30, 2000, date to September 30, 2003. Since the 504 program has a zero subsidy rate and therefore does not receive any appropriation, the program fees are critical to the continuation of the 504 program. SBA supports this extension of the critical program fees.

The fourth legislative change proposed is to make the Premier Certified Lender Program (PCLP) permanent. Certified Development Companies (CDCs) participating in PCLP are authorized to make credit underwriting decisions and service and liquidate loans that they believe are appropriate for this expedited process. Participating CDCs are required to establish loan loss reserve accounts for the loans that they approve using their PCLP authority, and must share 10 percent of any ultimate loss sustained on a PCLP loan.

Under existing legislation, PCLP would sunset on September 30, 2000. This proposal is in keeping with the Agency's strategy of placing greater reliance on its most qualified partners. Therefore, SBA supports the proposal to make PCLP permanent.

Currently, 24 CDCs participate in the program, and that number is increasing. The Agency believes that its experience with the program to date is sufficiently strong to justify making the program permanent. However, we do have some concerns regarding the specific language in the proposed statute, and would welcome the opportunity to work with the Committee and the 504 community to make some appropriate revisions.

Under the fifth legislative proposal, SBA would be prohibited from selling any defaulted PCLP loan in an asset sale unless the responsible CDC consented to the sale. The concern of PCLP CDCs is that they are required to share 10 percent of

any loss on a PCLP loan. Therefore, they believe they should be able to determine, on a loan-by-loan basis whether a loan should be included in the sale.

SBA cannot support this proposal. Both the Administration and the Congress have clearly indicated their desire to have SBA dispose of its direct and purchased loans on a timely basis. Asset sales are not intended to be "distress" sales. Rather, the Agency has established a process by which, using a model prepared by the private sector, it can forecast appropriate sales prices by category of loans being sold. We believe that the care with which we are proceeding with the asset sales program will help to assure maximum recovery on the loans. Therefore, given the critical importance of the Agency's asset sales efforts, we do not believe that SBA should be legislatively restricted from including any class of loans in its sales. We would, of course, welcome the opportunity to work with the Congress and with the 504 industry to assure that PCLP loans are appropriately handled in the Agency's asset sales.

Under the sixth legislative proposal, the current CDC liquidation pilot would be expanded and made permanent. The Senate passed a similar proposal last year after extensive discussion between the 504 industry and SBA.

The CDC liquidation pilot began in June 1997. To date, the 20 CDCs participating in the pilot have placed 74 cases in liquidation, and have concluded liquidation activities on 14 of these loans. In accordance with the authorizing

legislation, by September 30, 1999, SBA will provide a report to Congress on the first two years of the pilot's operation.

Preliminary indications are that pilot program performance has been generally very good. However, the Agency does not yet have the information and analysis necessary to make any final conclusions. We do believe that providing liquidation authority to qualified CDCs is in keeping with the Agency's overall strategy of relying on its partners.

Therefore, we believe that it is appropriate to expand the liquidation pilot and to make it permanent so long as appropriate safeguards are included. SBA would be pleased to work with this Committee and with the 504 industry to insure that the program meets appropriate public policy objectives.

In summary, SBA finds that many of the recommended legislative changes before this Committee have merit. We believe, however, that it is important for the Committee, SBA and the lending community to work together to insure that the proposals appropriately address all the issues before us, and that they do not result in any unintended negative consequences. We look forward to working with you on these important issues.

I very much appreciate your invitation for me to appear before you today, and would be happy to respond to any questions that you may have.

STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program
&
A Legislative Proposal for Program Improvement

Presented to the

COMMITTEE ON SMALL BUSINESS

UNITED STATES
HOUSE OF REPRESENTATIVES

by

Mr. John Giegel

NADCO Vice President for Congressional Relations
&
President
Wisconsin Business Development Finance Corp.
Madison, Wisconsin

June 24, 1999

Good morning Mr. Chairman and Members of the Committee. I am John Giegel. I serve as vice president for Congressional Relations of the National Association of Development Companies, the trade association for SBA 504 Certified Development Companies (CDCs). NADCO represents 250 CDCs and more than 130 affiliate members, who provided 95% of all SBA 504 financing to small businesses during 1998. NADCO's mission is to serve as the key advocate for the 504 program, thereby ensuring the viability of the most important economic development program in the country today. No other program can claim to have created over 500,000 jobs, as the 504 program has done.

I am also president of Wisconsin Business Development Finance Corporation, Wisconsin's statewide 504 Certified Development Company, with five offices throughout the state and the headquarters in Madison. We have provided more than $300 million dollars in 503/504 financing to over 1,000 businesses since 1981. We are ranked among the largest 10% of CDCs in the country in loan volume.

NADCO would like to thank you, Mr. Chairman, the Ranking Member, and the entire Committee, for your continued support of the 504 program and the CDC industry. It has been clear to us that the Committee recognizes the value of the program to the small business community.

I come to you today with two purposes. First, we believe there are areas in which the 504 program can be improved and extended to provide a greater scope of financial assistance to small businesses. Second, we strongly feel that the 504 program is in jeopardy unless action is taken to quickly deal with loan recovery and portfolio loss problems. NADCO proposes to address these two issues through a legislative proposal we submitted in April to this Committee. I would like to summarize our proposal and its impact on these concerns.

1. MAXIMUM DEBENTURE SIZE

The Small Business Investment Act of 1958 limits to $750,000 the maximum amount of a regular debenture issued by a certified development company. The current maximum for regular debentures was established in 1988. In 1990, legislation was enacted to provide a higher debenture limit ($1,000,000) if the debenture proceeds are used to assist with one of seven public policy goals:

- business district revitalization,
- expansion of exports,
- expansion of minority business development,
- rural development,
- enhanced economic competition,
- changes necessitated by Federal budget cutbacks, or
- business restructuring from Federally mandated standards or policies affecting the environment or the safety and health of employees.

The amount of the increase we are requesting is $250,000 for regular debentures and $300,000 for public policy purpose debentures. This increase merely reflects increases in the

Consumer Price Index (CPI) since these amounts were established. Actually, the cost of items funded by our debentures has increased in the same magnitude or even more than the CPI in some cases.

We ask the Committee to consider increasing the maximum size of our guaranteed debentures for two reasons. First, there has been a substantial increase in the cost of commercial real estate all around the country.

- Boston, MA - R. S. Means surveys indicate that commercial construction costs increased from $55 to over $70 per square foot since 1990, without considering land costs.
- St. Louis, MO - Commercial building costs increased an average of 25% for this metropolitan area since 1990.
- Long Island, NY - The average 10,000 square foot building in 1990 cost from $30 to $40 per square foot. Today, the average cost is more than $70 per square foot.
- Phoenix, AZ - Commercial real estate values have, on average, increased 10-12% per year over the past ten years.
- Milwaukee & Madison, WI – Over the past ten years construction costs, land values, and real estate prices have increased over 50%.
- New York City, NY: R. S. Means surveys indicate that the average price of a three-story commercial building in 1991 was $62 per square foot and in 1998 the average price of the same building had risen to $89 per square foot, a 44% increase.
- Los Angeles, CA: Commercial real estate has increased 10-12% from 1988 to 1998.
- San Antonio, TX: Commercial real estate values increased 24% from 1996 to 1998.

Congress intended that this program would reach growing small businesses that are creating new and well-paying jobs. We believe such jobs come from businesses who require a more expensive location than was the case in 1988.

Secondly, with the years of success of the 504 program, we see many small businesses continuing to grow and therefore, needing further expansion of their locations. Yet, many conventional lenders remain reluctant to provide long term financing for these borrowers. This is especially true in both inner-city and very rural communities where real estate values may be highly variable. In these locations, 504 is frequently the only source of long term capital available. Thus, the program must be able to respond to this capital gap by being able to possibly provide a second 504 to a successful growing urban or rural small business that continues to add jobs.

Using the consumer price index to measure inflation, application of the CPI to $750,000 in 1988 dollars would result in an increase to $1,050,232 in 1998; and similarly, $1,000,000 in 1990 dollars would be $1,283,548 in 1998. We ask the Committee to consider increasing the regular debenture ceiling to $1 million, and the public policy ceiling to $1.3 million, so that the program may continue to assist the small business sectors Congress intended in 1988.

2. WOMEN-OWNED BUSINESSES

As stated above, there are seven categories of assistance that are deemed to be public policy goals that allow the guarantee of debentures with a higher maximum amount. Women-owned businesses are not now included. Women-owned businesses are one of the fastest growing sectors of American small business today. Yet, women are finding it extremely difficult to obtain long term capital from traditional lenders.

Senate-passed legislation in 1998 added women-owned businesses to the public policy list, thereby increasing the maximum amount of debenture eligibility per borrower to $1,000,000. We strongly supported this program enhancement last year, and ask the Committee to reach out to this needy community of business owners through this addition to the public policy goals.

3. PROGRAM AUTHORIZATIONS

The Small Business Act provides an authorization for the appropriation of funds for the Small Business Administration to provide financing under the 504 or CDC program, but it restricts the maximum amount of loan guarantees it may provide in a given year. Historically, legislation has been enacted to provide this program authority for three-year periods.

The most recent law authorized SBA to guarantee CDC debentures in the amount of $3 billion, $3.5 billion, and $4.5 billion in each of fiscal years 1998-2000, respectively. We ask the Committee to provide debenture guarantee levels for three additional years, as proposed below:

- $3.5 billion in fiscal year 2001
- $4.0 billion in fiscal year 2002
- $4.5 billion in fiscal year 2003.

4. 504 PROGRAM USER FEES

There are three categories of fees under the certified development company program:

- the borrower pays an annual fee on the outstanding balance of the loan not to exceed 0.9375% (with the amount being set lower, if possible to maintain the 504 program subsidy rate at zero);

- the certified development company pays an annual fee on the outstanding balance of the debenture of 0.125%; and

- the bank or other first mortgage lender which participates in the project by providing an unguaranteed loan pays a one-time fee of 0.5% of the amount of its loan to the borrower.

These fees, however, are sunset October 1, 2000. Unless extended, there would not be funding to operate the program after that date.

We propose that the 504 program ceiling levels, discussed in item 3 above, and the needed fees be reauthorized during this session. We urge that the fee authority be extended for a similar period of three additional years.

Those are our proposals that address my first purpose; that of improving and extending the 504 program. Now I will turn to our recommendations to deal with our growing concerns about the loan recoveries of 504.

This Committee has already received testimony on the FY 2000 Administration budget and the 504 subsidy rates. The OMB forecasts for the loan defaults have fallen from 18.9% to under 12% in four years. This is through more than just improvements in the program. This decline is a clear testament to the ability of CDCs and SBA to efficiently deliver 504 as Congress intended it. We also believe that OMB is finally able to forecast an accurate default rate by taking a reasonable view of the fifteen-year performance history of our portfolio. Thus, we agree with their forecast, and recognize that CDCs and SBA field staff are doing a good job of meeting the borrower needs set forth by Congress.

However, recoveries from 504 loan defaults are another matter. The FY 2000 budget indicates the recovery for our portfolio by SBA Portfolio Management staff has fallen from 44% to under 25% in the last four years. This is further complicated by the admission that, for FY 1999, the recovery rate was not 30% as stated in last year's actual budget, but actually under 23%. Thus, we have questions about just how reliable any of these recovery calculations really are. Can we believe the forecasted 25% for FY 2000, or is it likely to be lower?

Whichever is the case, it is clear that we are headed in the wrong direction with the 504 recovery results. We believe that further action must be taken that cannot wait for even one more legislative session. Quick action on the part of Congress may mean the difference between long term survival or failure of the 504 program. We ask the Committee to consider the following requests:

5. PREMIER CERTIFIED LENDERS PROGRAM

Legislation enacted in 1994 (P. L. 104-403) authorized the Premier Certified Lenders Program (PCLP). Under this program, experienced CDCs may request SBA to delegate to them debenture approval authority; in return, they agree to reimburse SBA for 10% of any loss on a debenture guaranteed by SBA under the delegation of authority. The program was to originally sunset in 1997 and this sunset was subsequently extended to the end of fiscal 2000.

We believe that the program has proven itself during the past six years. It has reduced the time required to process a CDC loan, reduced the involvement of SBA personnel, and has not resulted in increased losses to the Government.

More CDCs are prepared to step forward to utilize this program in improving small business assistance, while reducing taxpayer exposure to loan losses. However, many are waiting to see if the program will become permanent, and are looking for detailed regulations and policy

guidance from SBA. Given the history of recovery by SBA, they are reluctant to agree to carry up to 10% of the total exposure until they can actively carry out full and effective independent recovery efforts. These must include all phases of the liquidation process -- INCLUDING the ability to litigate against the defaulted borrowers or loan guarantors.

We ask you to make this important and proven program permanent in order to expand the participation, and we request that SBA be directed to provide comprehensive PCLP Regulations for PCLP within one hundred and twenty days. These regulations should cover all phases of the process, including CDC litigation authorities as authorized by the congress two years ago. Without such guidelines, new PCLP CDCs will be unable to begin effective implementation of the program.

6. SALE OF DEFAULTED LOANS

As a condition of participating in the Premier Certified Lenders Program and being allowed to issue an SBA guarantee of the debenture, a CDC must agree to reimburse the agency for 10 percent of any loss SBA sustains due to a default and claim against the guarantee.

SBA is now preparing a pilot program to package and sell pools of defaulted loans, including both 7(a) loans and 504 debentures. Because a 7(a) lender owns part of the loan (i.e., the unguaranteed portion of the loan), SBA is required to obtain the prior consent of the lender before selling the whole loan. A lender conceivably would withhold consent if it believed that liquidation would produce a greater recovery than the planned SBA asset sale.

For 504 debentures issued under PCLP, the CDC assumes partial liability in the event of a default and ultimate loss. We believe that this potential 10 percent liability equates with ownership and that affected CDCs should be afforded a similar opportunity to insist on loan liquidation rather than recovery only through any SBA asset sale. This right to insist on liquidation rather than an untried sale will become even more important if the CDC qualifies for the delegation of liquidation authority (see item 7 below).

We ask the Committee to provide this right to liquidate their defaulted loans to PCLP CDCs. Given the recovery history of SBA, we believe fewer qualified CDCs will volunteer to assume increased portfolio risk without the right to directly recover project assets in the event of a loan default. Such authority for qualified CDCs should include all phases of the liquidation process, from loan workout negotiation, through asset sale, foreclosure, and litigation.

7. LOAN LIQUIDATION

Historically, if a small business borrower defaulted in repayment of a loan made by a CDC, the SBA handled foreclosure and liquidation of any available assets or suits against loan guarantors. As part of privatization and downsizing of government, CDCs suggested that they be authorized to perform the liquidation and foreclosure of loans they made. Our goal was to assist overburdened SBA staff by providing the added resources of both CDCs and outside subcontractors. The expected results were more timely recoveries and an increase in the percentage of recovery of the outstanding loan balance.

1996 legislation mandated the operation of a loan liquidation pilot program under which certain experienced CDCs would receive a delegation of authority from SBA. The pilot commenced in June 1997, and an SBA report to this Committee is due prior to the end of fiscal year 1999 on the first two years of the pilot operation.

In light of deteriorating SBA recovery statistics and preliminary pilot CDC performance, Senate-passed legislation in 1998 would have established a permanent CDC liquidation program in lieu of the limited pilot. An added benefit of making the program "permanent" rather than a "pilot" is that OMB, in computing the subsidy rate for the CDC program, would score the savings achieved by the CDCs liquidating their own loans.

The Senate bill also would have expanded the number of CDCs who could seek delegated authority to foreclose, liquidate, and litigate the defaulted loans. Given the reduced recovery percentage forecasted in the FY 2000 Administration budget, we are proposing several minor changes in the Senate-passed language. These proposals are explained in the sectional analysis already provided to the Committee.

One of the important benefits of our proposal for the program would be a quicker review and approval of liquidation and workout plans by SBA staff. As the Committee knows, in recovery of loan collateral, time is truly money. The longer an asset sits vacant, the more it deteriorates, is vandalized, or even "disappears" from its location. CDCs need the ability to quickly move to protect assets that have become government property through loan default. To perform this mission, the approval paperwork must be processed faster by SBA than it is today.

A second major benefit of our proposed language is the empowerment of qualified CDCs to use their internal or external contractor resources to perform the entire recovery process -- including full litigation against a defaulted borrower or guarantor. Just as time is so important in the recovery of value for assets, so the amount of staff effort is. The liquidation process is extremely labor-intensive. This is, in fact, SBA's main problem in the recovery process; the agency simply doesn't have enough qualified staff to perform recoveries for the growing 7(a), disaster, direct, and 504 loan programs. We strongly believe there are many highly qualified portfolio management and legal staff at SBA; there simply aren't enough of them.

NADCO realizes that some people may view our recommendations for expansion of this pilot as premature. The program has been functioning for two years. However, we feel there are five major reasons for proceeding with an expansion of the program:

1. Our funded portfolio continues to grow at a rapid rate, making it imperative that additional human resources be focused on loan loss control quickly.
2. SBA's field staff devoted to loan program management continues to shrink in proportion to the growing 7(a) and 504 portfolio size. This places growing pressure on an already over-burdened portfolio management, liquidation, and litigation staff.
3. CDCs have demonstrated their willingness to supplement the efforts of SBA staff in improving recoveries for 504. Further, through just the preliminary data from the pilot and the performance of CDCs for other managed lending programs, many CDCs have shown the ability to perform rapid and professional workouts and asset recoveries.

4. There is much to be gained from expanding this CDC program. The four-year trend of 504 recovery percentages is downward – from 40% to 34% to 30% to 25%. This area of the 504 program needs increased attention and resources if we are to reverse the growth of the program's borrower fees. A co-operative recovery program with SBA and CDCs will no doubt result in that needed attention and added resources.
5. CDCs have increased their focus on portfolio quality as the program has seen its subsidy appropriation eliminated. This emphasis is best shown by the reduction of the portfolio default rate from 19% three years ago to just 12% today. This demonstrates CDC skills in focusing on quality lending and servicing while reaching out to many diverse small businesses.

NADCO believes that, if CDCs are empowered by Congress to use both their available staff resources AND ALSO those who may be employed as outside contractors dedicated to assist in our recovery efforts, we can have a truly positive impact on the declining recovery percentage. But, to be successful, we must move quickly to expand both the pilot and authorities delegated to CDCs by SBA. We ask the Committee to consider our language slightly modified from the bill passed by the Senate last year.

SUMMARY

As you can see, there are many issues to be addressed for the 504 program if we are to both improve it, and stabilize the declining loan recovery rate. NADCO believes our proposals are extremely time-sensitive in their impact upon the program. The sooner the proposals are implemented by SBA, the faster we can begin to work together and obtain the benefits of these changes. We ask to Committee to take up consideration of our legislative package during this session, so that we can provide assistance to the agency as quickly as possible.

Thank you, Mr. Chairman, for allowing us to provide our comments today. CDCs are major stakeholders in the 504 Program and want to do everything we can to ensure its long term viability. We consider recovery problems a very serious matter, and we look forward to working with your Committee and the SBA in reversing the current trend quickly. Only through this effort can we bring the 504 program fees back to a reasonable level for America's small businesses.

I would be pleased to answer any questions from the Committee.



The National Association of
Government Guaranteed
Lenders, Inc.

Written Statement

of

Anthony R. Wilkinson

President
and
Chief Executive Officer

of the

National Association of
Government Guaranteed Lenders, Inc.

for the

Committee on Small Business

United States House of Representatives

June 24, 1999

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Good morning Mr. Chairman and Members of the Committee. My name is Tony Wilkinson and I am President and CEO of the National Association of Government Guaranteed Lenders (NAGGL). NAGGL represents nearly 700 lenders and other program participants who make approximately 80 percent of the 7(a) loans guaranteed by the Small Business Administration. We thank you for holding this hearing today and commend your efforts to move forward this year on a reauthorization bill for the 7(a) loan program.

Earlier this year, NAGGL shared with both the Majority and Minority staff of the Committee and with the Small Business Administration, the association's proposed legislative package. I would like to briefly review our proposals.

NAGGL's proposal contains six elements, several of which are interrelated, as follows:

1) Increase the maximum guaranteed portion of a 7(a) loan from $750,000 to $1,000,000 and establish a new gross loan maximum amount of $2,000,000. NAGGL believes this increase is justified because the current maximum loan amount of $750,000 was established by P.L. 100-418, enacted in 1988. Inflation alone justifies the proposed increase. Using the Consumer Price Index (CPI) to measure inflation and applying increases in the CPI from 1988 to 1998 to the maximum guarantee of $750,000 would result in an increase to $1,050,232. Applying projected CPI increases to 2000 to the maximum guarantee would move the amount to approximately $1,100,000. 1988 dollars simply do not buy today what they could have bought eleven years ago.

An increase in the maximum amount of the guaranteed portion of a 7(a) loan would likely result in some new loan demand. We estimate additional loan demand to be in the range of $400 million a year in guaranteed loans. We also point out that this proposal would have a positive subsidy rate effect since these larger loans are

subject to the highest guarantee fee (3.875 percent) and thus would generate additional cash flow to the federal government. And, NAGGL believes the establishment of a $2 million gross loan amount would help control program demand.

2) For several years there has been a continuing and significant problem with loan prepayments, according to SBA and other sources. A substantial number of borrowers are obtaining long term SBA financing but then prepaying it during the first few years after obtaining the loan. We have appended to our testimony prepayment information received from SBA that was compiled by Colson Services Corporation, the fiscal and transfer agent for SBA's secondary market. NAGGL believes this data shows prepayments are a significant problem. If the prepayment problem continues, there could be serious policy consequences. A substantial portion of the income received by SBA on 7(a) loans comes from the 50 basis point fee on outstanding loan balances. If prepayments continue unabated, the income to the government would decrease, the value of the 50 basis point fee in the subsidy model would decrease, and future program users would have to absorb higher fees or Congress would have to appropriate more dollars. NAGGL believes that the cost burden of prepayments should be borne by those who choose to prepay, not future program users.

Additionally, NAGGL believes conventional lenders are pirating seasoned SBA loans and converting them into conventional loans once a borrower proves a repayment capability. The result is that the 7(a) program, in some instances, is used as a bridge loan program. This aspect of the prepayment issue could ultimately result in a lower overall quality of the 7(a) portfolio, again requiring a new round of fees to support a given program level.

NAGGL's proposal is to establish a prepayment penalty. The penalty would be payable to SBA, by a borrower who elects to make, within the first five years of the loan, an excessive prepayment on a long term loan with an original maturity of 15 years or more. The phrase "excessive prepayment" would be defined as a payment in

excess of 20 percent of the amount of the loan outstanding in any year, reduced by the regularly scheduled principal payment. In other words, a borrower could still prepay 20 percent of the outstanding balance of the loan in any one year without paying a penalty. The rate of the fee would be determined by the date of prepayment: five percent of any excessive prepayment amount in the first year, four percent of any excessive prepayment in the second year, three percent of any excessive prepayment in the third year, two percent of any excessive prepayment in the fourth year, and one percent of any excessive prepayment the fifth year.

Mr. Chairman, prepayments on conventional commercial loans, both fixed rate and variable rate, are common. Furthermore, we note that SBA's 504 loan program has a prepayment penalty and that the Business and Industry Loan Program in the Rural Development Division of the Department of Agriculture provides for a prepayment penalty. We believe NAGGL's proposal to enact a prepayment penalty only on excessive prepayments on long term loans is a sound one. It is in the interest of the program and in the interest of future borrowers.

3) NAGGL believes it is time, as further reductions are made in the 7(a) subsidy rate, to begin reducing program fees. Currently, there is a one-time guarantee fee imposed on the borrower, the amount of which is determined by the size of the loan. Except for loans with guaranteed portions of $80,000 or less which have a 2 percent guarantee fee, borrowers are required to pay:

- 3 percent on the first $250,000 guaranteed
- 3.5 percent on the second $250,000, and
- 3.875 percent on amounts above $500,000 guaranteed

In addition, there is an on-going fee of 50 basis points (0.5 percent per annum) of the outstanding loan balance that is paid by the lender for the life of the loan.

In recent years, the 7(a) subsidy rate has fallen due to improved underwriting and program improvements. However, federal funding for the program has also declined. Program participants have reaped no benefits from an improving program. NAGGL believes borrowers should receive some benefits from an improving program and it is time to begin reducing fees. Accordingly, NAGGL proposes establishing a 1.25 percent subsidy rate floor. If program performance continues to improve or if Congress enacts NAGGL's suggestion for an increased loan size or an excessive prepayment penalty thereby generating cash flow for the government, SBA should be directed to begin a staggered reduction in the amount of fees paid by borrowers:

- first, the rate on the first $250,000 guaranteed would be reduced to 2 percent
- second, the rate on the second $250,000 would be reduced to 3 percent
- third, the rate on amounts over $500,000 would be reduced to 3.5 percent
- fourth, the 50 basis point lender fee would be reduced.

This subsidy rate initiative is modeled after what already exists in the SBA 504 Certified Development Company Program where SBA is statutorily authorized to impose fees up to specific levels to keep the 504 program at zero.

These three initiatives are interrelated in that they together would help eliminate program abuse while enhancing program use for future borrowers. NAGGL's other three legislative recommendations are as follows:

1) In 1996, as part of the changes designed to reduce the 7(a) subsidy rate, legislation was enacted to reduce the amount of a claim against SBA in the event a loan defaulted. Instead of basing SBA's liability on the amount of the unpaid principal and interest at the rate provided in the loan agreement, SBA's liability for accrued interest was reduced by 100 basis points, with the lender picking up this cost. However, according to SBA the subsidy rate has not declined (per OMB), and the

costs of compliance far outweigh the benefits. Accordingly, we ask that this provision be repealed.

2) Generally, SBA loans may not be used for investment purposes. In 1997 Congress recognized that in some instances it would promote a borrower's business for her or him to be able to lease out a small part of the property to a third party for a separate business activity. For example, a convenience store leasing out a small part of the property to a food service operation. Thus, Congress passed legislation, affecting the 504 Certified Development Company Program, authorizing a 504 borrower to lease out on a permanent basis, up to 20 percent of the property constructed with the proceeds of a 504 loan. We believe this same exception should apply to the 7(a) program.

3) Finally, NAGGL recommends the following authorization levels for the 7(a) program in future years:

- $14.5 billion in fiscal year 2001
- $15.0 billion in fiscal year 2002, and
- $16.0 billion in fiscal year 2003.

Please note that NAGGL is recommending flatlining the authorization level from the year 2000 to the year 2001 as Congress has already authorized a $14.5 billion program level for fiscal year 2000.

Thank you again Mr. Chairman. We look forward to working with you to hopefully expeditiously move the reauthorization bill at an early date.

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Statement of Donna Faulk
The Bond Market Association

before the

Committee on Small Business
United States House of Representatives

June 24, 1999

Thank you and good morning. My name is Donna Faulk, and I am a Vice President at Prudential Securities, Inc. I am here today representing The Bond Market Association, where I am the Chair of the Association's Government Business Loan Committee. The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally.

The Bond Market Association's members include numerous firms like my own who are active in the secondary market for loans guaranteed under the Small Business Administration's (SBA's) section 7(a) program, and for pool securities backed by those loans. Last fall, I testified before this committee's Subcommittee on Government Programs and Oversight on issues related to the secondary market for 7(a) loans. In my testimony, I raised several concerns regarding the management of the 7(a) program and issues which we believe could, if ignored, threaten the viability of the secondary market for 7(a) loans. Unfortunately, the problems I raised in my testimony last year persist, and have perhaps even worsened. It is particularly timely, therefore, that the Committee is meeting today to discuss possible improvements to the 7(a) program. We commend Chairman Talent for holding this hearing, and we appreciate the opportunity to present our views. We strongly support the changes to the 7(a) program proposed in the draft legislation.

My testimony last fall outlined in detail a number of recommendations we have made to the SBA to improve the 7(a) program. Rather than repeat them in total here, I would prefer this morning to concentrate on three issues: the troubling trend towards higher prepayment rates on 7(a) loans; the SBA's unjustifiable and harmful practice of diverting premium refunds on certain 7(a) loan pools, and the draft legislation.

Prepayments on 7(a) loans



Over the past several years, we have noticed an alarming increase in prepayment rates among 7(a) borrowers. For example, according to data provided by Colson Financial Services, to date nine percent (as measured by total dollar amount) of section 7(a) loans that were settled during calendar year 1998, and which had original terms of 15 to 25 years and loan sizes between $500,000 and $750,000, have prepaid. The trend of early prepayments among 7(a) borrowers, especially for longer-term loans with large balances, has been increasing over the past several years.

In many cases, loan prepayments can be indicative of the improved financial health of a borrower. If a small business generates greater-than-expected net income, it may be able to repay its debt faster than anticipated. A 20-year loan might be paid off in, say, 15 years. This form of prepayment behavior is expected in any lending market where borrowers are able to prepay loans at any time without penalty, and can be viewed as a success of the 7(a) program. However, we believe recent trends in the pattern of certain prepayments among 7(a) borrowers suggest not a success of the program, but a threat to its effectiveness. If a significant and growing number of 7(a) borrowers prepays long-term, 15-25 year loans within the first few years after origination, a strong argument can be made that Congress' intent in crafting the program—to provide affordable, long-term capital to small business borrowers who could not obtain such capital through conventional lending channels—is not being met.

Recent trends also suggest that many of the 7(a) loans that prepay very early do so not because borrowers met with unanticipated success and were able to pay down debt from business profits. Rather, it is evident that much of the early prepayment activity results from the actions of conventional lenders who market refinancing transactions to 7(a) borrowers. Often, the non-SBA refinancing loans carry marginally better terms—lower interest rates, longer maturities, etc.—than SBA loans. Very early prepayments on 7(a) loans result from these refinancing transactions. At first glance, this may appear to be a desirable outcome of the 7(a) program. Borrowers are "graduating" to conventional financing. However, if a borrower is able to qualify for a conventional, non-federally-guaranteed loan shortly after settling on an SBA-guaranteed loan, it is highly likely that the borrower did not need the SBA guarantee in the first place to qualify for financing. In essence, the borrower is using the 7(a) program as a form of short-term bridge financing. It is also likely that another, more needy borrower was displaced and could not obtain SBA financing as a result. Moreover, this very fast refinancing activity is the result of "cherry-picking." Lenders offer refinancing transactions to only the most attractive and credit-worthy SBA borrowers. Those loans that are not refinanced—the loans that remain federally guaranteed and through which the federal government is exposed to default risk—tend to be riskier.

Very fast prepayments also affect the marketability of 7(a) loans in the secondary market. Pools of SBA-guaranteed loans are priced in the secondary market based on assumptions regarding the prepayment speed of loans in the pools. If an unexpectedly large number of

loans prepays very early, an investor's rate of return on his or her investment is affected. Eventually, investors will begin to demand higher rates of return on SBA-guaranteed loan pools to compensate for inordinately fast prepayments. Indeed, we have begun to witness this effect in the secondary market for 7(a) loans as a result of prepayment behavior. Higher rates of return for investors translate into higher borrowing rates for small businesses. These problems associated with high prepayment rates would be exacerbated if, as proposed in the draft legislation, section 7(a) loan limits were increased without directly addressing the prepayment issue.



Premium refunds

One result of the trend towards higher levels of very early prepayments relates to premium refunds on 7(a) loans. In many cases, 7(a) loans sold to investors in the secondary market are sold at premiums, or prices in excess of face value. This occurs because the interest rates on the loans exceed market rates of interest for obligations having similar expected maturities and credit characteristics. If a 7(a) loan bears an interest rate of, say, 10 percent, but an investor demands only a seven-percent yield, that investor would be willing to pay a price higher than face value for a 10-percent loan. Buying loans at a premium can be risky. If a premium loan prepays at face value too quickly, an investor's return can be significantly and negatively affected. The investor will not receive the return of its premium, and therefore will realize a principal loss.

As a result, the 7(a) program includes a premium refund provision. If a 7(a) loan is sold in the secondary market and prepays within 90 days of the warranty date, the originator of the loan is required to refund to the purchaser the amount of the premium. Unfortunately, as a result of an apparently arbitrary and unfounded decision by the SBA, this provision is not being properly observed or enforced in the case of certain 7(a) pool securities.

In applying the premium warranty provision, the SBA has drawn a distinction between "premium pools" and "par pools." A premium pool exists when a pool of loans is sold in its entirety at a price above face value. A par pool exists when the "excess" coupon on the premium loans is "stripped" and sold separately. The loan pool itself is sold at face value, or par.[1] The SBA has decided that in the case of par pools, any premium refunds paid by lenders should be passed through on a pro-rata basis to premium-strip investors. This outcome is fair, appropriate and consistent with program rules. However, the SBA has decided that in the case of premium pools, any premium refunds paid by lenders should not be passed on to investors. Rather, these premium refund payments are being diverted to the SBA's own Master Reserve Fund. This practice is harmful to the 7(a) program and is totally unjustifiable. We have conducted a thorough analysis of the terms and provisions of the 7(a) program, and we have found no legal justification for the

[1] Recall the example involving a ten-percent pool where investors demand a seven-percent yield. If the pool were sold as a par pool, the loan pool itself would be sold at face value (par) with a seven-percent yield. The extra three percent of interest paid by borrowers would be sold to investors as an interest-only strip security.

SBA's practice of diverting premium refunds that rightfully belong to premium loan pool investors.



We have raised the premium warranty issue numerous times with SBA staff both in meetings and in follow-up correspondence. Indeed, we have requested in the strongest possible terms that the SBA immediately stop this harmful practice. In response, the SBA has offered no sound justification for its practice of diverting premium refund payments that belong to premium pool investors to the SBA's own reserve fund. The Association believes that the SBA's practice not only harms particular registered holders who are denied the return of premiums they have paid, but damages the reputation and efficiency of the secondary market in which Section 7(a) obligations are traded. To the extent that dealers and investors in the secondary market believe that their basic contractual entitlement to protection against premium losses will not be honored, their willingness to make active markets and provide essential liquidity to the small business lending sector will diminish, ultimately harming small business borrowers. We therefore wish to repeat in the strongest possible terms the Association's continuing objection to the SBA's current practices in this regard.

The draft legislative language

The draft legislation providing for changes to the 7(a) program includes a provision for modest, graduated prepayment charges for borrowers who prepay their long-term loans in the first five years. The Bond Market Association strongly supports this provision. We support it because we believe it would apply only to loans that, by their terms, are intended to supply long-term business financing, and would therefore discourage the number and volume of extraordinary, early prepayments which are harmful to the 7(a) program. It would do so without penalizing borrowers who, as a result of business success over a reasonable time frame, are able to repay loans more quickly than expected. Discouraging very early prepayments without penalizing businesses who prepay loans later in their terms strikes an appropriate balance. By reducing prepayment risk to investors, prepayment charges also arguably would benefit borrowers through lower financing costs. If investors view their 7(a) loan investments as less risky, they will demand lower rates of return, which in turn translates into lower borrowing costs for small businesses. This effect has been documented in other loan markets where prepayment charges have been introduced.

Discouraging very early prepayments, as the proposed legislation would do, would also go far towards addressing the most harmful aspects of the SBA's practice with regard to premium refunds. Since under the proposed legislation fewer borrowers would prepay loans very early in their lives, there would be relatively few premium refunds paid by borrowers, which are required only in the event of very early prepayments. We still believe that premium refunds previously paid by lenders and diverted to the Master Reserve Fund should be returned to investors, to whom the warranty payments rightfully belong. Going forward, any future premium refunds paid by lenders should be passed through to premium pool investors, rather than diverted to the Master Reserve Fund.

Presumably, however, the prepayment charge provision would significantly reduce the volume of loans prepaid very early in their terms.

Summary



We believe that the SBA's section 7(a) loan guarantee program is effective and successful. It is a proven and efficient source of long-term capital for small businesses that otherwise would find it difficult or impossible to qualify for financing. An active and robust secondary market for 7(a) loans has been and remains vital to that success. Our concerns regarding the program are focused on a few issues that if left unchecked, could threaten the viability of the secondary market in 7(a) loans. Our most significant concerns relate to the direct and indirect effects of inordinately high prepayment rates. Unusually high levels of very early prepayments represent not a sign of the program's success, but rather a threat to its continued viability.

We strongly support the prepayment provision in the draft legislation. That provision would address many of the concerns we have regarding prepayment behavior and the SBA's practice of diverting premium refunds. We urge the Committee to adopt the prepayment provision in its reauthorization of the SBA's programs, and we are committed to assisting in this process in any way possible.

6

Appendix

The secondary market for 7(a) loans



Congress created the SBA in 1953 to aid, counsel, assist and promote small business and expand access to capital by guaranteeing private loans. Such loans were expected to carry longer terms and lower interest rates than small businesses would otherwise be able to obtain in a private commercial lending transaction. The secondary market for SBA loans began in 1975 when market participants and the SBA worked together to allow for the sale of the guaranteed portions of SBA loans. The program permits the lender of an SBA loan to retain the unguaranteed portion and servicing of the loan and sell the guaranteed portion to a secondary party, often a dealer, who then may re-sell the SBA-guaranteed loan to an investor, transferring full rights of the government's guarantee. This secondary market liquidity frees lenders' capital for the origination of additional small-business loans, thereby giving small businesses valuable access to more capital.

In 1984, the Small Business Secondary Market Improvement Act provided for the central registration and servicing of loans sold in the secondary market by a single fiscal and transfer agent, Colson Services Corporation. In addition, the 1984 Act allowed for the pooling of SBA loans with the intent of providing increased efficiency, better liquidity and a more established and improved SBA product in the secondary market. Accordingly, such improvements allowed secondary market participants to structure securitized SBA loans to be attractive to institutional investors by creating pools of similar loans diversified geographically and by amount, lender and industry sector, and provide a timely guarantee of monthly principal and interest to investors. In sum, each of these legislative, regulatory and market developments has served to further recognize, expand and improve the efficiency and liquidity of the secondary market in SBA loans. However, even with such improvements, we believe that the secondary market for the7(a) program could be further strengthened by addressing targeted issues.

The Benefits of Secondary Market Activities

Securitization and secondary market trading of loan pools were introduced into the U.S. capital markets on a widespread basis in the early 1970s with the creation of the Government National Mortgage Association, or Ginnie Mae. Ginnie Mae, by providing credit support for securitized FHA and VA mortgages, made it possible for home mortgage lenders to sell pools of loans into the secondary market. Since that time, the market for securitized home mortgages has blossomed. In 1998, more than $726 billion of agency MBS were issued.

Secondary market activities, including the trading of whole assets as well as the conversion of pools of assets into tradable securities, have also evolved in the markets for a wide range of other financial assets. It is now quite common for lenders to sell or securitize car loans, credit-card receivables, lease contracts, trade receivables, even royalties from intellectual property, among other assets. Last year, nearly $200 billion of

publicly offered ABS were issued, and this year promises even higher volume. The SBA permits the trading and securitization of both the guaranteed and unguaranteed portions of loans made under the 7(a) program. Securitization of the guaranteed portion of loans is much more common, and since 1985, $23 billion of SBA-guaranteed loans have been securitized or sold in the secondary market.

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The secondary market provides several benefits for lenders and borrowers. First and perhaps most important, securitization provides lenders with a ready and efficient means of selling assets in order to raise capital to generate additional lending. Rather than being forced to carry a loan on its books for its entire term, lenders are able to sell loans to investors and use the proceeds of the sale to make additional loans. Second, securitization attracts sources of capital to lending markets that would never be available otherwise. Securitized SBA loans are sold to a wide range of investors, including pension funds, mutual funds, insurance companies, endowment funds and others. Few, if any, of these investors would ever consider making a small business loan directly. However, because securitized loans are standardized and liquid, they are easily marketable to a variety of investors. Third, the secondary market gives financial institutions and other lenders flexibility in managing the assets on their balance sheets. As market conditions and business strategies change, lenders are able to expand or contract their balance sheets easily and efficiently, for example, to better match their assets and liabilities. In combination, the existence of liquid and efficient secondary markets for SBA debt obligations has resulted in more widespread availability of capital, at lower cost, for small business borrowers.

The secondary market has become an increasingly integral component of the 7(a) program. As a result, it has become ever more important for program administrators to be sensitive to issues that affect the secondary market for SBA-guaranteed loans. Issues such as liquidity and investor confidence have become important to the success of the SBA's programs. If investor confidence in securities backed by SBA-guaranteed loans wanes, the 7(a) program would suffer significantly. Fundamentally, we believe that the 7(a) program is well designed and well managed. The program meets the needs of small-business borrowers and benefits the economy overall in ways that no other government initiative does. By implementing targeted changes, the program could be made stronger and more beneficial to America's small businesses.

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DONNA FAULK

Ms. Faulk's professional career has focused on the Small Business Administration's (SBA's) guaranteed loan program since the inception of the secondary market in the mid-1970s.

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Ms. Faulk was associated with regional securities dealers in Houston and Milwaukee through the mid-1980s. Her positions involved educating the lending community on the 7(a) secondary market program and trading 7(a)-guaranteed loans. She served on the industry committee that drafted the original rules for good delivery of section 7(a) loans which were later adopted by The Bond Market Association.

In 1985, Ms. Faulk joined the firm serving as the SBA's fiscal and transfer agent in its inaugural. She served several years with the mandatory and exclusive agent for the SBA secondary market. During this time, Ms. Faulk worked with a team of dealers and the SBA to develop the guidelines for SBA pool securities, and as a liaison to dealers, lenders and investors.

Ms. Faulk later joined a private investment fund in Atlanta as Managing General Partner and Portfolio Manager. She designed the SBA interest-only security as its primary investment vehicle.

Since October 1992, Ms. Faulk has served as a Vice President on the mortgage-backed trading desk with Prudential Securities, Inc. as a market maker in 7(a)-guaranteed loans and pool securities. Prudential Securities has been a pioneer and currently leads the market in the securitization of unguaranteed 7(a) loans.

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To Whom It May Concern:

Over the last three years, The Bond Market Association has not been the recipient of any federal grants or contracts.

Signed,

Michael Decker
Vice President, Policy Analysis