BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

SBA's 7(a) Loan Guarantee Program: An Assessment Of Its Role In The Financial Market

The Small Business Administration's 7(a) Loan Guarantee Program, which enables commercial lenders to provide long-term loans to new and expanding small businesses, is one of the Federal credit programs proposed for budget cuts. GAO looked at the 7(a) program's role in assisting small businesses.

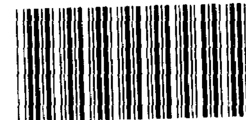
This report

--discusses factors that limit long-term lending by commercial banks to small businesses and how the 7(a) program helps lenders fill this "credit gap";

--explains how the secondary market process, wherein lenders sell the guaranteed portion of 7(a) loans to private investors, helps provide additional capital for other small business borrowers; and

--presents a detailed analysis of SBA's interest rate policy for 7(a) guaranteed loans.

Recommendations and alternatives are presented to the SBA Administrator and the Congress to improve the 7(a) Loan Guarantee Program's responsiveness to small businesses' financial needs.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the role of the Small Business Administration's (SBA's) 7(a) Loan Guarantee Program in assisting small businesses. It points out that recent administration proposals to reduce the program's funding could weaken SBA's ability to help small businesses obtain long-term financing. The report also explains how lenders can obtain additional funds for small business lending by selling SBA loans to private investors. Finally, the report addresses the need for SBA to change its interest rate policy on guaranteed loans.

We initiated this review to determine how the 7(a) program interacts with the credit market in financing small business ventures. Subsequently, the Chairman, Senate Committee on Small Business, asked us to respond to several questions concerning the program, sales of loans to investors, and SBA's policies on regulating interest rates.

We are sending copies of this report to the Chairmen of the House and Senate Committees on Small Business; the Director, Office of Management and Budget; and the Administrator, SBA.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

SBA's 7(a) LOAN GUARANTEE PROGRAM: AN ASSESSMENT OF ITS ROLE IN THE FINANCIAL MARKET

DIGEST

The Small Business Administration's (SBA's) primary lending program enables commercial lenders to make long-term loans to small businesses which SBA guarantees to repay in the event of borrower default. The program is authorized by section 7(a) of the Small Business Act of 1953.

The administration is considering reducing the 7(a) program's budget from about $3 billion to about $1 billion over the next 5 years. These reductions could seriously weaken lenders' ability to respond to small businesses in need of long-term financing.

GAO initiated a study to determine how the 7(a) program interacts with the credit market in financing small business ventures. After the study had started, the Chairman, Senate Committee on Small Business, asked GAO to respond to several issues concerning the role of the 7(a) loan guarantee program, the selling of loans to private investors, and SBA's policies on regulating interest rates. (See app. I.)

SMALL BUSINESSES BENEFIT FROM 7(a) GUARANTEED LOANS

GAO sent questionnaires to 951 lenders participating in the program to determine what role the SBA guarantee plays in their small business lending practices. These lenders were scientifically selected from among 8,900 lenders that made SBA-guaranteed loans during fiscal years 1979-81 to include a representative number of small, medium, and large banks.

GAO received and analyzed 739 responses. These responses showed that the SBA guarantee was an important factor in banks' decisions to lend to new businesses and to businesses with less equity than banks usually require. About 82 percent of lenders responding indicated that 7(a) guaranteed loans either would not have been made without the SBA guarantee or

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would have been made on more stringent terms. Several lenders also cited examples of how 7(a) loan assistance helped small businesses provide jobs. (See p. 18.)

Banks are more willing to make longer maturity loans to small businesses with the guarantee. For example, lenders responding to GAO estimated that 74 percent of SBA guarantees carry maturities of 6 or more years, whereas only 15 percent of non-SBA small business loans carry such lengthy maturities. Long-term loans help small businesses to maintain an adequate cash flow. (See p. 21.)

The guarantee increases banks' ability and willingness to make larger loans because the guaranteed portion of the loan does not count against federally regulated lending limits. Some 43 percent of responding lenders said the guarantee enabled them to make larger loans than otherwise permitted by bank policy or Federal regulations. (See p. 23.)

Although banks are using the program to make larger loans, only 28 percent believe that the guarantee limit should be increased from $500,000 to about $900,000. On the other hand, a majority of banks indicated that their participation in the 7(a) program would not be affected if SBA reduced the guarantee percentage from 90 to 80 percent. However, it is possible that such a reduction could have some adverse effect on marginal borrowers. (See p. 25.)

Losses on 7(a) guaranteed loans have been steadily increasing. Accordingly, SBA is emphasizing higher quality lending practices to reduce these losses. However, comments from banks and SBA officials indicate that in certain instances quality standards may have been overemphasized. Because higher quality standards are a recent initiative, it is important that SBA review field office practices to see whether they are being consistently followed. (See p. 32.)

SBA has not collected program demand data needed to estimate the impact of the administration's proposed budgetary reductions on small businesses' ability to obtain long-term loans. Such information is needed to assist the Congress and the administration in

deciding the program's proper size in the context of overall Federal credit policy. (See p. 25.)

SECONDARY MARKET POTENTIAL NOT FULLY DEVELOPED

Lenders can sell the guaranteed portion of SBA loans to investors in the secondary market and thus rapidly recover 90 percent of their funds. These funds can be reloaned to other borrowers, including small businesses. In practice, only about 15 to 20 percent of guaranteed loans have been sold because many lenders have not needed more capital due to a depressed economy. (See p. 46.) Nevertheless, the secondary market process has the potential for helping more small businesses if SBA makes administrative improvements.

Lenders sold about $1.5 billion in SBA loans in the secondary market during the last 3 fiscal years. GAO estimates that about $400 million may have been recycled to small businesses. Lenders who have been active in the secondary market said that it has enabled them to use the proceeds from the sales to make more small business loans. Other benefits of the secondary market are that by preselling the loan to an investor for a specified rate, lenders can offer fixed rate loans and lower interest rates. The secondary market also enables lenders to make loans for longer terms. (See p. 38.)

The secondary market process needs improvement in a number of areas. Investors buy loans at lower interest rates than lenders charge the borrower. The lender keeps the difference in interest rates as a fee for servicing the loan. The fee is determined more by the interest rate that the investor is willing to accept than the lender's servicing costs. Therefore, lenders can significantly increase their profits on SBA-guaranteed loans through secondary market sales. Although some lenders have used this process to reduce small business borrowing costs by reducing the rate they charge on a loan, most have not. (See p. 48.)

Concerns over inconsistencies in the way interest payments are calculated on SBA-guaranteed loans, lack of timely payment,

and other administrative problems have caused some investors to discontinue purchases. (See p. 58.)

SBA oversight of the secondary market process has been hampered because (1) records on sales are inaccurate and incomplete, (2) staff roles and responsibilities have not been clearly defined, and (3) goals and objectives for the process have not been formalized. (See pp. 44 and 62.)

ALTERNATIVE INTEREST RATE POLICIES FOR SBA-GUARANTEED LOANS

GAO assessed whether or not SBA should continue to set an interest rate ceiling and concluded that the decision to retain or eliminate the ceiling is a policy matter that the SBA Administrator should decide. However, GAO believes SBA can improve its method of calculating the ceiling, if retained.

SBA currently uses the prime rate--a short-term interest rate--as its benchmark for calculating the maximum rate allowed on fixed and variable rate loans. SBA should discontinue using the short-term prime rate as a benchmark for fixed rate loans because it has the interest rate risk of long-term debt. SBA should instead ensure that its fixed rate loans are priced consistently with other long-term debt. Treasury notes and bonds of comparable maturity, or other long-term instruments, are more suitable benchmarks for fixed rate loans. (See p. 72.)

Variable rate loans, regardless of their stated maturities, have an interest rate risk similar to short-term loans because interest rates can be adjusted quarterly. GAO identified the prime rate, large Certificates of Deposit, and Treasury bills as suitable benchmarks for variable rate loans. (See p. 76.)

MATTER FOR CONSIDERATION BY THE SENATE AND HOUSE COMMITTEES ON SMALL BUSINESS

GAO suggests that the committees propose legislation requiring SBA to accumulate and integrate loan demand data into future 7(a) budget proposals. This data, based on past and forecasted economic conditions, would give the committees a better basis for establishing

future program authorization levels. (See p. 37.)

RECOMMENDATIONS TO THE SBA ADMINISTRATOR

GAO is recommending improvements to the 7(a) Loan Guarantee Program designed to ensure consistency among SBA district offices in applying loan quality standards and to improve the budget process by accumulating data on 7(a) loan applications, approvals, and rejections to project future demand for 7(a) loan assistance. (See p. 36.)

Recommendations for improving the secondary market process include formalizing its goals and objectives, developing better recordkeeping procedures, clarifying methods for calculating interest rates, and using the process to offer small businesses the option of fixed rate financing. (See p. 66.)

GAO is also recommending changes to SBA's current interest rate policy to better ensure reasonableness. (See p. 83.)

SBA COMMENTS AND GAO's EVALUATION

SBA basically agreed with the report. But SBA did not fully agree with a proposal that GAO made in a draft of this report to establish controls on the amount of lender servicing fees. While in agreement with the intent of the proposal, SBA was unsure whether it could be implemented. (See app. IV.)

GAO recognizes that implementing this proposal is best left to the discretion of the SBA Administrator. Accordingly, GAO now recommends that, if the Administrator decides to regulate service fees, a period of testing be carried out. During the test period, SBA should determine whether it is feasible to control service fees based on loan size, the length of time the loan is held, whether the loan is sold at a premium, and whether the lender expects to perform extraordinary servicing. (See p. 67.)

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ABBREVIATIONS

FmHA Farmers Home Administration

FTA fiscal transfer agent

GAO General Accounting Office

MSBFA Minnesota Small Business Finance Agency

SBA Small Business Administration

CHAPTER 1

INTRODUCTION

The Small Business Administration (SBA) was established in 1953 to serve and represent small businesses and from its inception has provided financial assistance to small businesses. SBA's major financial activity--the 7(a) Loan Guarantee Program --permits lending institutions to make loans to small businesses which SBA guarantees to repay if the borrower defaults. In the past 5 years over 105,000 7(a) guaranteed loans totaling $12.4 billion were made to small businesses.

The program also allows lenders to sell the guaranteed portion of the loan to private sector investors. This process, commonly called the secondary market, enables lenders to tap into investment sources such as insurance companies, pension funds, and money market funds that traditionally do not lend directly to small businesses. This additional financing can then be recycled by the lenders to other small business borrowers.

This report examines how SBA's 7(a) Loan Guarantee Program, in concert with the secondary market process, meets the credit needs of many small businesses that private lending institutions are generally unwilling to finance. This report also contains a detailed analysis of SBA's policy for regulating interest rates on 7(a) guaranteed loans.

THE 7(a) LOAN GUARANTEE PROGRAM

In the 1930's, 40's, and early 50's the Department of Commerce, the Federal Reserve Board, and others conducted independent studies of small business financing. These studies concluded that a serious credit gap existed for small and medium size businesses because their access to equity and bond markets was limited and banks were generally reluctant to lend them money on a long-term basis. Section 7(a) of the Small Business Act, as amended (15 U.S.C. 636(a)), authorized SBA to make direct loans or to guarantee loans made by private lenders to small businesses that cannot otherwise obtain reasonable financing. The 7(a) program offers repayment terms and collateral requirements that better fit the borrower's needs than might be obtainable under usual bank policy and transfers the major risk of borrower default from the private lender to SBA.

SBA administers the 7(a) Loan Guarantee Program through its headquarters office, 10 regional offices, and 96 district and branch offices. The network of district offices is responsible for day-to-day operation of the 7(a) program. Within the district office:

--The financing division reviews loan application packages and recommends approval or disapproval of loan applications.

--The portfolio management division services loans, refers loans to the management assistance division, and represents SBA at foreclosures.

Headquarters develops and recommends agencywide program policies, reviews and evaluates program effectiveness, and provides technical assistance to the regional and district offices.

Processing 7(a) loan guarantees

The 7(a) loan guarantee system consists of three principal parties--SBA, the small business borrower, and the private lender. The private lender, generally a commercial bank, plays the central role in the loan delivery system. The borrower usually submits the application to, receives the loan funds from, and makes payments to the lender.

Private lenders make the initial review of the loan application. The lender then forwards the application and supporting documents to the local SBA district office. SBA requires the lender to certify that credit is not available elsewhere at reasonable terms and that the loan will not be made without the SBA guarantee. The application package also includes the lender's evaluation of loan benefits and the applicant's ability to repay the loan, the adequacy of the collateral securing the loan, and any other pertinent loan comments.

SBA must determine whether or not a 7(a) loan should be approved. SBA loan officers perform a detailed analysis of each application in addition to the lender's evaluation. This analysis includes determining the applicant's eligibility for a 7(a) loan, ability to repay the loan, and capability to obtain funds without a guarantee. The adequacy of collateral pledged to secure the loan and the applicant firm's management personnel are also evaluated. The loan officer prepares a report on the analysis and recommends loan approval or denial.

After approving a guarantee loan, the SBA district office notifies and provides the lender with the legal documents needed to close the loan. The lender can then disburse the loan funds to the small business borrower. SBA guarantees 90 percent of loan amounts under $100,000 and from 70 to 90 percent for loans exceeding this amount. SBA has a $500,000 guarantee ceiling for one loan or total of loans to one borrower. The guarantee pledges the full faith and credit of the United States and obligates SBA to purchase the guaranteed portion of the loan from the lender upon borrower default.

GROWTH OF THE LOAN GUARANTEE PROGRAM

The 7(a) Loan Guarantee Program grew rapidly until fiscal year 1973, as shown in table 1. Since then, the program's overall growth has slowed. As discussed in a previous GAO report[1] general economic conditions were largely responsible for fluctuations in program activity between 1973-80. The business recession was primarily responsible for the sharp decline in the number of 7(a) guarantee loans made during 1974 and 1975. Likewise the decline in 7(a) loans for fiscal year 1979 can be partly attributed to uncertainty with the economy and high interest rates. According to SBA and bank officials, the sharp drop during 1981 and 1982 reflected volatile interest rates, depressed economic conditions, and the administration's emphasis on reducing SBA loan defaults by tightening credit checks on 7(a) loan guarantee applicants.

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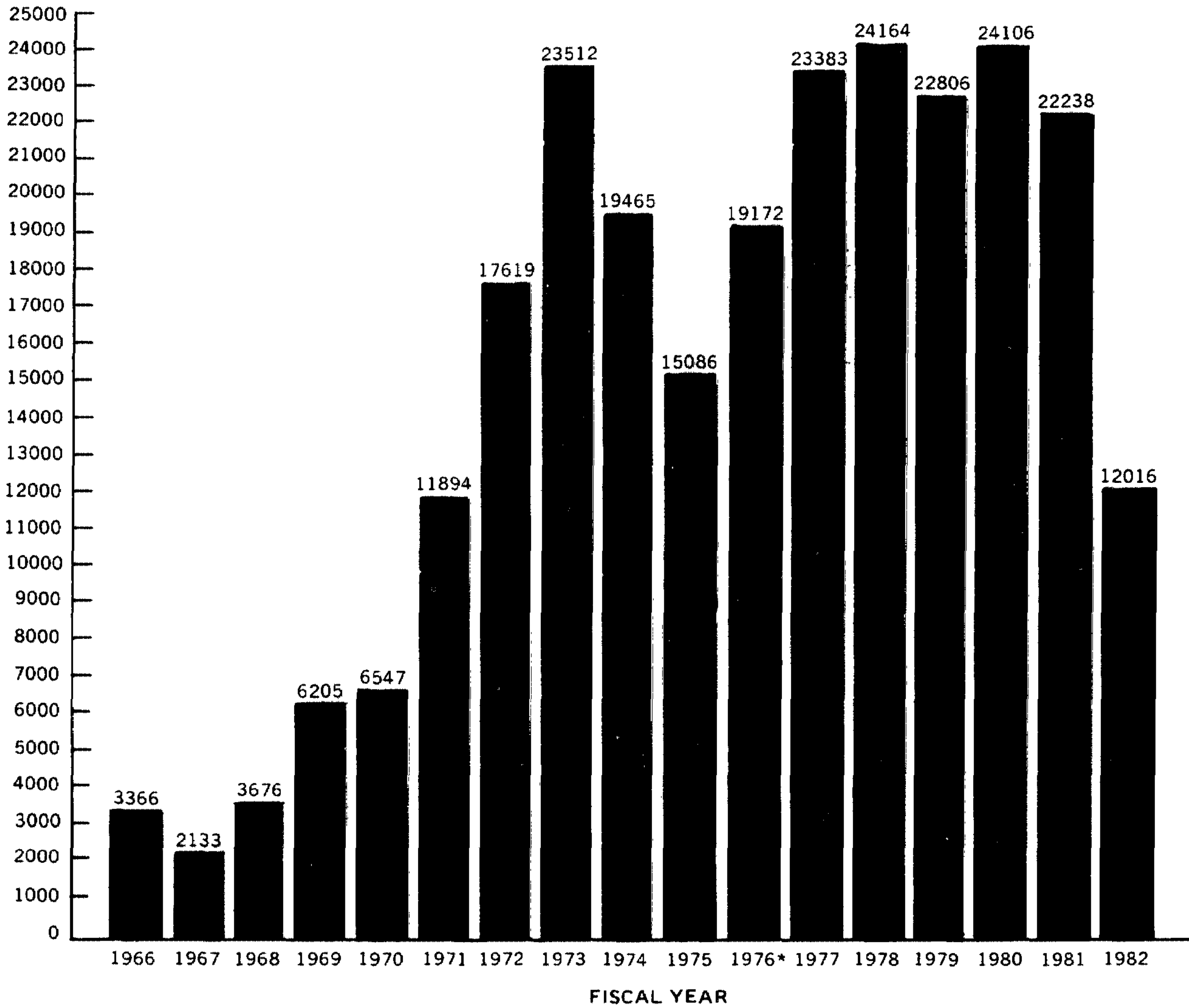
[1]"SBA's Pilot Programs To Improve Guaranty Loan Procedures Need Further Development" (CED-81-25, Feb. 2, 1981).

Table 1

7(a) GUARANTY LOANS MADE PER YEAR

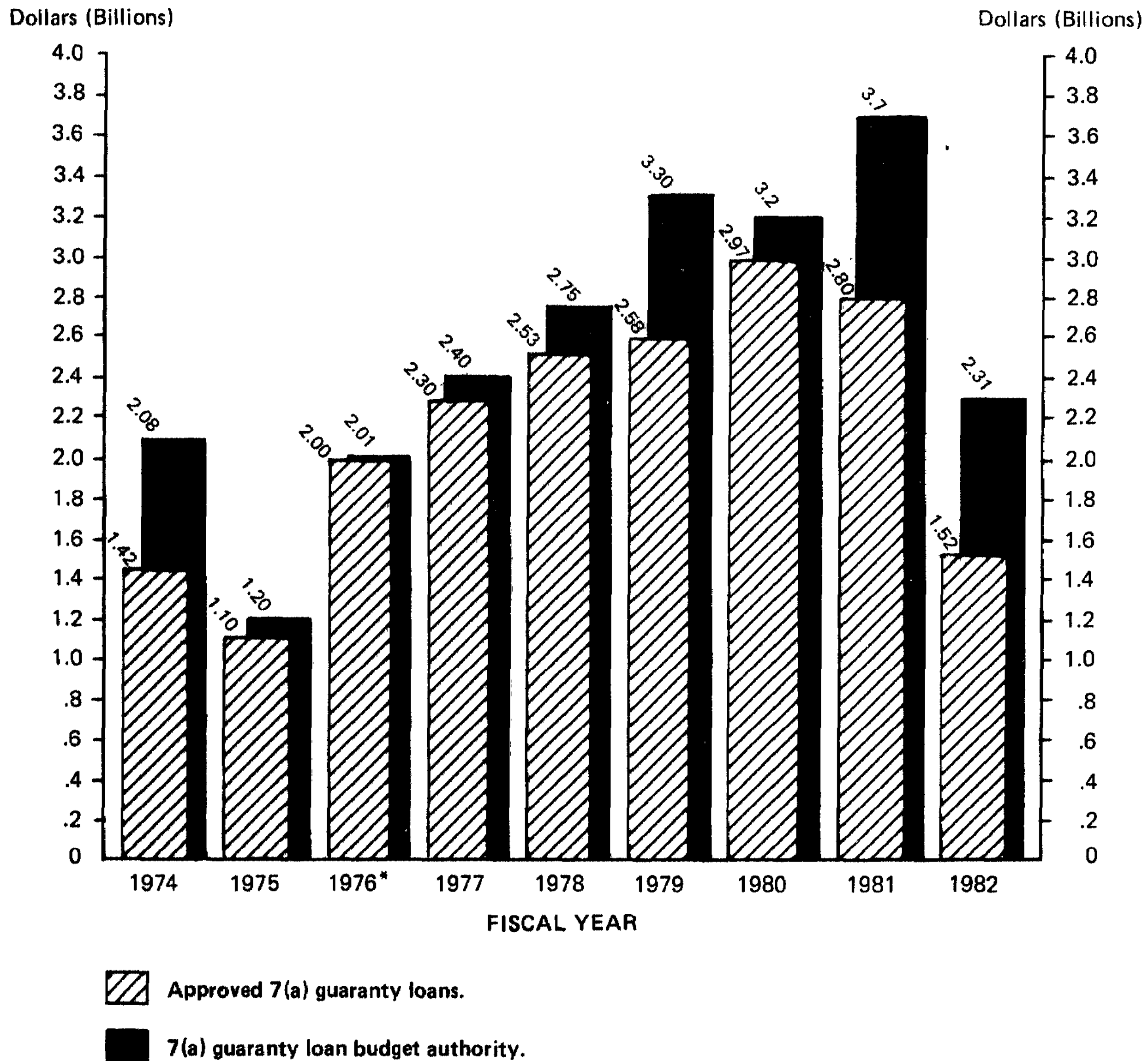


*Transitional quarter, July 1 to September 30, 1976, was eliminated

Until 1979, increases in loan approvals paralleled increases in budget authority with the one exception being 1975 when both budget authority and loan approvals significantly decreased, as shown in table 2.

Table 2

APPROVED 7(a) GUARANTY LOANS COMPARED TO BUDGET AUTHORITY AVAILABLE FOR FISCAL YEARS 1974-82



*Transitional quarter, July 1 to September 30,1976, included.

THE SECONDARY MARKET FOR SBA-GUARANTEED LOANS

The secondary market is a process designed to permit a lender to sell the guaranteed portion of an SBA loan to an investor. Secondary market sales of SBA loans have been permitted since 1972. Initially, there was little lender interest in the process and little promotion of it by SBA. However, in the mid-1970's, SBA placed more emphasis on the process and established a position--Director of Secondary Markets--to promote and improve it.

SBA identified two informal objectives for authorizing the sale of its loans in the secondary market. The first is to increase the flow of capital to the small business community by allowing lenders to sell the guaranteed portion of loans to investors who are not normally direct lenders. The second is to lower the cost of borrowing to small businesses. SBA believes that lender competition for small business loans will increase because the secondary market improves lender liquidity and yields. SBA expects that increased competition will lower borrowing costs while making more funds available to small businesses.

How the secondary market operates

A lender that wants to sell the guaranteed portion of a loan looks for an investor either directly or through a broker/dealer. After an investor is found, a sales agreement is prepared and signed by the lender and the investor. It is then submitted to the local SBA district office for review. After SBA determines that the loan is properly closed and disbursed, payments are current, and there is no indication of impending problems, SBA signs the agreement. By signing the agreement, SBA guarantees the payment of loan principal and interest to the investor should either the borrower or lender default.

After selling the loan, lenders continue to be responsible for servicing the entire loan including the guaranteed portion sold in the secondary market. The lender's level of profitability on a sale is determined by the difference or spread between the interest rate charged the small business borrower and the interest rate accepted by the investor. This spread is commonly referred to as the lender's servicing fee.

At the option of the lender and the investor, either of two methods can be used to execute the sale. Under the first method the lender, investor, and SBA sign a secondary participation guarantee agreement (SBA form 1084). The investor then receives all loan documentation, including the loan note, and the lender remits payment directly to the investor. Under the second

method the lender, investor, and SBA sign a secondary participation guarantee and certification agreement (SBA form 1086). The lender then provides the loan documents to SBA's fiscal transfer agent (FTA) which holds these documents for the investor. The lender also remits payments to the FTA which in turn forwards them to the investor. The advantages of the second method are:

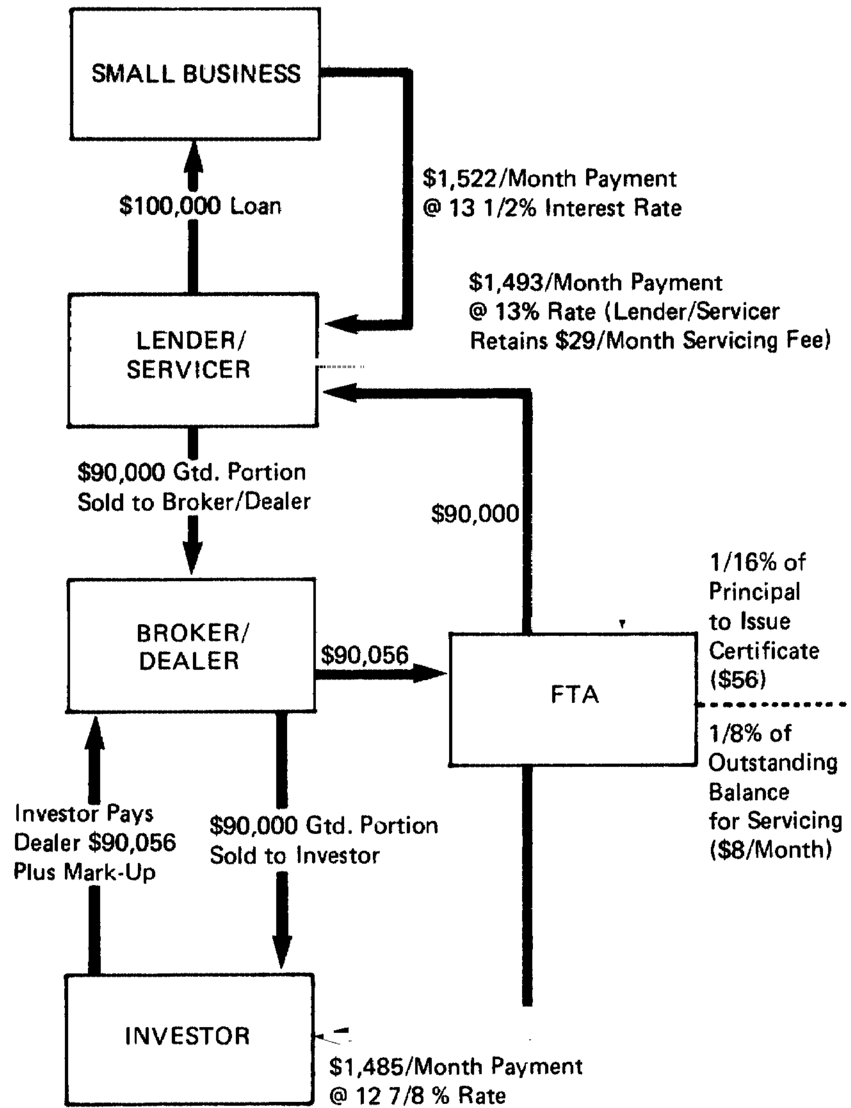
--It allows lenders to remit to the FTA and investors to receive from the FTA a single payment on all loans sold or purchased.

--It allows investors to simplify their files because the loan document package is replaced by a single certificate as evidence of ownership.

--The certificate can be transferred to another investor somewhat more easily than the entire loan document package.

Since 1979 SBA's designated FTA has been the Bradford Trust Company of New York. In return for its services the FTA deducts a fee of one-eighth of 1 percent of the outstanding balance of the guarantee from each payment passed through to the investor. In addition, it charges a one time fee of one-sixteenth of 1 percent of the guaranteed principal amount of the loan to issue the certificate.

The following diagram illustrates the secondary market process, using the example of a $100,000 loan, 10-year term, 13-1/2-percent interest rate, and the 90-percent guaranteed portion sold by a lender/servicer who retains one-half percent of the outstanding balance for servicing.



OBJECTIVES, SCOPE, AND METHODOLOGY

Our initial review objectives were to

--examine how the secondary market in SBA-guaranteed loans operates,

--assess whether small businesses are benefiting from the secondary market, and

--determine whether improvements to the secondary market are needed to increase its responsiveness to small businesses.

During our review the Senate Committee on Small Business requested that our study be expanded to include an assessment of several policy issues affecting SBA's loan guarantee programs. These issues included determining the overall importance of the SBA guarantee to the willingness and ability of commercial banks to lend to small businesses; determining to what extent, if any, the SBA guarantee program affects the "credit market" or the ability of small businesses not using the program to obtain credit; and identifying options for regulating interest rates on SBA-guaranteed loans.

The committee's letter dated July 28, 1982 (see app. I), stated that it was requesting that we pursue these additional issues because of its concern over recent reductions in the loan guarantee authority and proposed revisions to interest rate regulations. Our study of the secondary market, which is entirely dependent on the basic guarantee program, provided an excellent mechanism to respond to the committee's request.

To accomplish our original objectives as well as those requested by the committee, we met with and collected data from commercial bankers and their trade associations, nonbank participants in the guarantee program, brokers and dealers, and investors in SBA-guaranteed loans. We also met frequently throughout the course of our review with SBA's Director for Secondary Market Operations and senior SBA headquarters officials, including the Assistant Deputy Administrator for Investment; the Director, Office of Finance; and the Director, Office of Program, Policy, and Evaluation.

We developed a survey questionnaire that was sent to a nationwide sample of 951 commercial banks that made loans through SBA's guarantee program during fiscal years 1979-81. For this purpose banks were divided into three groups--those with total assets under $100 million, those with assets between $100 million and $1 billion, and those over $1 billion. The reason for grouping the banks was to minimize the sampling errors of the estimates. Questionnaires were sent to all banks for which total assets were over $1 billion and were sent to independently selected random samples of banks in the other two groups. Of the 951 questionnaires mailed, 739 usable responses were received for an overall response rate of 78 percent. The questionnaire was designed to determine

--how the SBA guarantee affects banks' decisions to lend to small businesses,

--why banks choose to either sell or not sell SBA loans in the secondary market,

--how the guarantee program affects bank lending to other small business borrowers, and

--what changes to the guarantee program and secondary market would be desirable.

A detailed explanation of our sampling methodology is contained in appendix II. The questionnaire and a summary of banks' responses is contained in appendix III.

We supplemented the data collected through the questionnaire with discussions with Federal banking officials and visits to 20 banks of varying sizes that were active in the guarantee program. We collected data on Federal bank regulations that constrain commercial bank small business lending, and we discussed how the guarantee and secondary market overcome these constraints. To gain a further understanding of banks' use of the guarantee program and the secondary market, we visited SBA offices in Chicago, Illinois; Clarksburg, West Virginia; Columbus, Ohio; Indianapolis, Indiana; Madison, Wisconsin; and Philadelphia, Pennsylvania. Discussions were held with senior SBA field staff and data was obtained pertaining to each of the review objectives.

We contacted nine of the largest investors in SBA loan guarantees to determine their attitudes toward the guarantee and the secondary market process. Our survey of investors consisted of a series of questions that we developed with the help of a major broker/dealer. We collected data on investors' reasons for purchasing SBA-guaranteed loans, problems they experienced with their purchases, and changes that would improve the attractiveness of SBA loans as an investment. We also discussed with brokers and dealers how the secondary market functions and possible improvements.

We analyzed SBA data on over 71,000 loan guarantees made during fiscal years 1979-81 to compare interest rates charged by lenders on loans sold and those not sold to determine the secondary market's influence on interest rates charged small businesses. We also obtained data from the Federal Reserve System's "Survey of Terms of Bank Lending" and compared it with data on SBA-guaranteed loans to determine how the guarantee affects interest rates.

We coordinated closely with SBA's Committee on Capital Access and discussed with its representatives the relative advantages and disadvantages of various options to interest rate regulations for the 7(a) program. We also reviewed recent administration proposals on interest rate regulations and bank responses to these revisions. We reviewed current literature

and studies on bank lending practices mainly for the purpose of developing background information. We did not review the studies for technical quality. Our review also did not include an independent analysis of the financial needs of small businesses or the relative priority that the 7(a) Loan Guarantee Program should be afforded in the context of overall Federal credit policy.

This review was conducted in accordance with generally accepted government audit standards.

CHAPTER 2

SBA's 7(a) LOAN GUARANTEE PROGRAM

IS VITAL TO MANY SMALL BUSINESSES

The Nation's 11 million small businesses make an important contribution to the economy by employing an estimated 58 percent of the country's work force. SBA's 7(a) Loan Guarantee Program helps many small businesses sustain and expand operations and enables entrepreneurs to compete and gain entry into the economic mainstream. Bank regulatory requirements, internal bank policies, depositor preferences for short-term investments, and widespread shifts among market-sensitive instruments constrain private lending institutions from meeting the long-term capital needs of many small businesses. According to lenders we surveyed, about 82 percent of the 7(a) guarantee loans they made would not have been made without the guarantee or they would have required small business borrowers to accept more stringent loan terms and conditions.

Small business borrowers are getting SBA loans at interest rates comparable to those charged other small business borrowers even though SBA loans are for longer terms and have a higher degree of risk. At the same time, lenders can sell SBA loan guarantees to private investors (such as pension funds) to obtain additional financing for other loans, including those to small business borrowers.

Not unexpectedly, losses on 7(a) loans are high compared with banks' nonguaranteed loans. The program's goal--to help overcome private lender concerns about financing new ventures and providing long-term financing--inherently leads to increased loan risk.

The current administration is emphasizing better quality 7(a) loan approvals to cut down on the number of defaults. However, SBA should evaluate implementation by its field offices to see whether loan quality standards are clear and are being applied consistently.

The administration has forecasted reductions in the 7(a) guarantee program as part of its efforts to curtail the overall expansion of Federal credit programs. The 7(a) program, by allocating credit to small business, has some impact on the capital market. However, because the 7(a) Loan Guarantee Program is such a small part of overall Federal and private sector credit assistance, its impact on interest rates and capital flows cannot be precisely isolated.

Accurate data on the demand for 7(a) loan assistance is limited. Consequently, it is difficult to determine what size program is required to meet the needs of the small business sector. Also, factors that have been considered in the past, such as increasing the maximum loan amount from $500,000 to $1 million and reducing the percentage of the guarantee below 90 percent, would have a bearing on the program's size.

Recent high interest rates have curtailed small businesses' plans for expansion and have discouraged new business starts. A general economic upturn will likely stimulate small business expansion and lead to a greater demand for the 7(a) guarantee program. Because the program is important to small businesses' ability to obtain long-term debt and has a limited impact on credit markets, the administration should carefully monitor and consider demand for the program in establishing funding levels.

SMALL BUSINESS HAS A NEED FOR LONG-TERM FINANCING

A healthy small business sector--crucial to the Nation's economy--needs adequate capital to continue its important role. The 7(a) program has prompted commercial lenders to provide long-term financing to small businesses. Recent depositor preferences for short-term investments and widespread shifts among market-sensitive instruments may further hamper lenders' ability to provide long-term capital to small businesses. Although data on small business demand is sketchy, several studies indicate an unmet need for credit, especially long-term credit.

Healthy small business sector crucial to Nation's economy

Small business is a key element of the Nation's economy. In 1981 the Congressional Research Service (CRS) reported that there were about 11 million small businesses in the United States. According to CRS these businesses employ about 58 percent of the country's work force and account for almost half of the private sector's gross national product. The report also shows that almost 75 percent of new employment comes from the small business sector. For example, between 1969-76 small businesses created an estimated 12 million new jobs; Federal, State, and local governments created an estimated 3 million new jobs; and the 1,000 largest corporations created an estimated 1 million new jobs.

Unfortunately, unemployment continues to be a major economic problem. Unemployment went over 10 percent in September 1982--the highest since the depression levels of the 1930's. It is estimated that every 1-percent increase in unemployment

costs the Federal Treasury $25 billion. The Government is penalized two ways since it pays out benefits to unemployed workers at the same time tax revenues are being reduced.

Small businesses require long-term capital to begin new companies and to expand and grow. The jobs created and the taxes paid by small businesses can play an important part in reducing persistently high unemployment. However, various studies show that private lending institutions are reluctant to provide small businesses the long-term financing that is often necessary for business expansion.

History of small business financing problems

Small businesses require long-term debt financing for a variety of reasons including plant expansion and acquisition and equipment purchases. However, they have had problems obtaining such financing as far back as 50 years ago and the problems that small businesses faced then are the same today.

One of the earlier studies of small business financing in the United States was made in 1935 by the Department of Commerce. The study surveyed over 6,100 U.S. manufacturers that employed between 21 and 250 employees. A striking conclusion of the study was that about 50 percent of all manufacturers said they could not obtain long-term funds from any source whatsoever. After reviewing individual financial statements, Commerce Department personnel estimated that almost two-thirds of these firms could be considered sound credit risks.

A Committee for Economic Development was formed at the end of World War II to study the credit problems of small businesses. The committee--comprised of U.S. business leaders--concluded that a fundamental need of small- and medium-size businesses was more adequate financing, especially long-term credit.

The Federal Reserve Board submitted a 1952 study to the Senate Small Business Committee on the cost and availability of credit and capital to small businesses. The report stated that available long-term debt and equity capital to small businesses had diminished somewhat over the past two or three decades.

The Senate Committee on Banking and Currency held 9 days of public hearings in June 1957 on credit needs of small businesses. Once again, overwhelming opinion was expressed that a serious credit gap existed and that many small- and medium-size businesses particularly were unable to meet their needs for long-term credit or equity capital.

Recent studies shed additional light on the financing problems facing small businesses today. For example, an Interagency Task Force on Small Business Finance,[1] as part of its study directed by Public Law 96-302, surveyed a random sample of 224 banks nationwide. The study, issued in January 1982, indicated that 25 percent of established small business loan applications were rejected by banks usually because the owners' equity was inadequate. For new businesses with no track record, the study found the rejection rate to be about 50 percent. The task force also received about 2,000 responses to a notice published in the Federal Register asking small businesses about their experiences with obtaining bank credit. About 505 firms that had less than 20 employees and less than $800,000 in annual sales gave the following responses to the October 1981 notice:

--Twenty-six percent said that commercial banks inadequately met their credit needs.

--Thirty-five percent said that they had some difficulties in obtaining bank credit.

In June 1982 a private nonprofit group, assisted by a commercial bank, issued a report on the unmet credit demand in a national sample of the business population. The analysis, commissioned by the Department of Commerce, included businesses' experiences in obtaining debt capital during a 2-year period--October 1979 through October 1981. Usable responses were submitted by 2,889 firms about their inability to obtain credit as follows.

Type of credit sought but not obtained	Responding firms Percent	Number
Unsecured short-term	21.0	607
Unsecured intermediate-term	22.6	653
Secured long-term	25.2	728

Several important conclusions were reached that highlight small businesses' problems in obtaining credit. For example, the study concluded that the youngest and smallest firms consistently have difficulty accessing credit markets. The difficulty increases when young and small firms try to obtain longer term credit.

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[1]The task force consisted of representatives from the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Bureau of the Census, and SBA.

Impediments hindering lenders from meeting long-term financing needs of small businesses

Commercial lenders have been held back in the past from providing long-term financing by regulatory requirements and internal policy limitations. Also, recent depositor preferences for short-term investments and widespread shifts among market-sensitive instruments further constrain long-term fixed rate financing by commercial lenders.

Banks are hindered from some long-term financing by Federal and State regulations. For example, the Federal Deposit Insurance Corporation limits a bank's portfolio mix of short- and long-term financing so that a proper match of a bank's asset/liability ratio is maintained. The Comptroller of the Currency requires banks to follow certain capital asset guidelines. For example, banks with guaranteed loans that are considered as liquid assets may not have to maintain as much capital as other banks to comply with the Comptroller's guidelines. Also, banking law imposes a limitation on the size of any individual loan that a bank can make. As a general rule, banks have been prohibited from making loans to one borrower in excess of 10 percent of their capital and surplus.[1] However, under 12 U.S.C. 84, exemption 10, the 90-percent guaranteed portion of a loan does not count against this lending limit. This exemption allows lenders to make guaranteed loans up to 10 times larger than conventional loans with the amount at risk the same.

Many banks have established internal policies that limit the number of years a business can have to repay a loan. For example, several bank officials told us that small businesses would not be extended credit for maturities exceeding 5 years without a Federal guarantee.

Banks have also been hampered from providing long-term fixed rate financing because of the recent shift of funds out of passbook and other savings accounts into short-term investments. Trends toward 90-day, 6-month, and 2-year Certificates of Deposit have also led banks to variable rate pricing of loans.

Recent demand for credit sluggish due to high interest rates

The recent high interest rates and general poor economic climate have kept small business demand for credit significantly

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[1]These loan limit restrictions were increased under certain circumstances up to 15 percent by section 401 of the Garn-St Germain Depository Institutions Act, dated Sept. 29, 1982.

below normal levels. About 37 percent of lenders indicated that loan applications from small businesses have decreased compared with 3 years ago due to

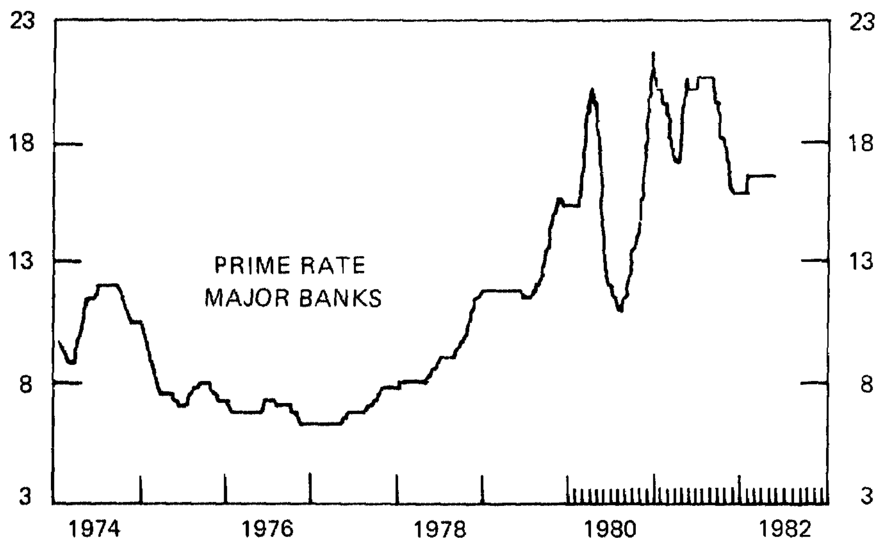
--high interest rates,

--depressed local economy, and

--fewer new business starts.

The volatility of interest rates since 1979 is illustrated by the following chart.

The Prime Lending Rate
1974-82



During periods of high interest rates, businesses are more likely to cancel or delay expansion plans--including opening new plants, hiring more workers, or obtaining new equipment. A 1982 study by Arthur Andersen and Company indicated that interest rates of less than 12 percent were essential before 90 percent of the 813 responding small businesses would consider business expansion. The survey of businesses located in Pennsylvania, Delaware, and New Jersey showed that 56 percent believed a 12-percent or lower interest rate was needed for business viability.

SBA's 7(a) LOAN ASSISTANCE HELPS MANY SMALL BUSINESSES

Over the years SBA's 7(a) Loan Guarantee Program has been the Federal Government's answer to small businesses in need of long-term financing. Over 105,000 loans totaling $12.4 billion have been approved in the past 5 years. These businesses included industries such as retail and wholesale sales, services,

manufacturing, construction, and farm-related activities. These small business loan recipients averaged 11 full-time employees. Because of numerous variables, no direct relationship can be made between the number of jobs created or saved resulting from an SBA loan guarantee. However, there was a perception among a number of lenders that the 7(a) Loan Guarantee Program had an important impact on employment in their geographical areas.

A banker in Louisiana commented about the job creation benefit of SBA loans as follows:

> "We have been with the program since 1970. Our experience has been very satisfactory. In that period, we have made over 400 loans totaling $60 million. These have created or saved 6,000 total jobs. We could not make these loans to our small business customers without the guarantee."

Another banker in West Virginia commented:

> "We did an informal survey. In the past four and one-half years, there are more than 150 more people with jobs in our area because of this program. This is 150 more people paying taxes and bringing additional income into the area."

About 82 percent of lenders said that the small businesses to which they made loans would not have been financed without the SBA guarantee or would have had different financing terms and conditions. Although it is difficult to project what would have happened without the SBA Loan Guarantee Program, banks are often reluctant to make unguaranteed loans to small businesses under terms or conditions suited to their needs. Entrepreneurs contemplating the start of new businesses often find that financing is difficult to obtain. Many commercial lending institutions consider new business ventures as poor risks. Such ventures usually are supported by weak collateral and lack an established track record.

The objective of promoting full and free competition is specifically cited in section 2(a) of the Small Business Act (15 U.S.C. 631(a)). In line with this objective, SBA's mission is to accept riskier loans and guarantee financing to firms that could not get credit on reasonable terms in the open market. SBA's 7(a) program is designed to meet this need.

Respondents to our questionnaire identified the major factors that contributed to their decision to use SBA loan guarantees as shown in the following chart.

Extent That Factor Contributed to Bank Use of SBA Guarantee

Factor	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent
	-(Percent of Responses in Each Category)-				
1. Able to offer longer maturity loans	16	25	24	14	21
2. Able to offer loans to owners who have less equity in businesses than would be required for non-SBA loan.	21	39	18	12	10
3. Able to offer loan to new business (without established record).	17	38	19	13	13
4. Able to make larger loan than bank's policy permits	13	18	12	12	45
5. Able to make larger loan than regulated lending limit permits.	13	14	8	8	57
6. Average of five other factors (note a)	6	6	14	13	61

a/Included among other factors were that SBA guarantees allow banks to (1) offer more favorable interest rates, (2) hold the guarantee as security for public funds or as collateral for Treasury and loan accounts, (3) make loans to line of business not generally served by bank, (4) use SBA loans (with secondary market sale option) as hedge against future bank liquidity problems, and (5) other.

7(a) guarantee allows lenders to finance new business ventures

The policy of the Congress is that the Government shall aid, counsel, and assist small business concerns as much as possible to preserve free competitive enterprise. One of the Congress' major purposes in enacting small business legislation was to help small businesses compete in the economic mainstream. The need for a 7(a) loan program was based on the premise that private lending institutions shied away from financing small business ventures.

About 55 percent of lenders indicated that the SBA guarantee, to a great extent, allowed the bank to offer loans to new businesses without an established record. Sixty percent said that the guarantee, to a great extent, enabled them to offer loans to owners with less equity in the business than would be required for nonguaranteed loans. Several comments from lenders follow.

From a Montana bank:

"We operate in a small, low-population, rural area that is quite capital short. The ability to obtain SBA assistance on new business requests for loans has allowed us to make loans which would not have been made otherwise thus enhancing the amenities of the people who live here as well as facilitating the ability for those who want to live here to own and run their own businesses."

From a Connecticut bank:

"The program effectively provides capital to small business borrowers where ordinarily there would be none available (e.g., "start ups"), * * * has loaned capital to many start up situations that could not have begun without the SBA program. Many of these companies have been very successful and are now actually sources of capital (because of their large deposits at * * * and investments elsewhere)."

From a New York bank:

"It is our opinion that the SBA Guaranty program is a very effective and worthwhile program which is highly utilized by many banks and will continue to be a useful tool through which banks may help newly established businesses through their rough years, and also

help established businesses to grow and prosper in these difficult, recessionary times we are faced with. This program is the "shot in the arm" many businesses need to survive, not to mention the added security to the Bank. (90 percent Guaranty)."

The Independent Bankers Association of America--representing about 7,400 small banks--also referred to the riskier businesses helped by SBA guarantees in its February 1982 letter to the Senate Committee on Appropriations, Subcommittee on State, Justice, Commerce, and the Judiciary, by commenting:

"* * * the 7(a) program continues to focus on riskier new small business ventures which show real promise for success. As such, the SBA loan guarantee effort remains fully justifiable as a counterbalance to the fact that private credit markets without any guarantee tend to overemphasize the risk of such new small business ventures and to underallocate funds to this type of small business * * *."

7(a) guarantee enables lenders to make long-term loans

Small business borrowers are getting long-term financing from lenders through SBA-backed loans. Lenders estimated that 74 percent of SBA loans carried maturities of 6 or more years whereas only 15 percent of the lenders' loans without SBA guarantees carried similar maturities. In fact, about 52 percent of normal lender financing is for less than 1 year. The following chart shows the percentage of various maturities for lenders.

Maturity period	SBA loans	Non-SBA small business loans
	(percent)	
Under 1 year	2	52
1-5 years	24	33
6-10 years	59	11
Over 10 years	15	4
Total--all loans	100	100

Our analysis of other data sources confirmed the banks' responses. SBA loan statistics for fiscal years 1979-81 indicated that the average maturity was 6.3 years for 71,000 approved loans. In contrast, our analysis of the Federal Reserve System's Survey of Terms of Bank Lending report for the quarter ending August 1982 showed the weighted average maturity was under 3 years for all commercial and industrial loans of comparable size to SBA loans.

An adequate cash flow--the lifeline of a small business operation--is aided by spreading out the time to repay a loan. About 65 percent of lenders indicated that the existence of a Government guarantee contributed from a moderate to a very great extent to their ability to make longer term loans. The following are several comments made by lenders about the long-term lending advantages of SBA guarantees.

From a Nebraska bank:

> "Without question, term loans for small businesses are necessary and this is a very viable tool for small businessmen to use as a means of structuring their business debts. We feel that this has been an excellent program."

From a South Carolina bank:

> "Through proper employment of the 7(a) program,--a lending institution can extend interest rates and repayment terms otherwise not available to most small businesses."

From a Vermont bank:

> "The program enables us to make loans to small business people of promise and integrity whose financial statements do not yet warrant conventional bank credit and also enables us to make these loans for longer terms and under conditions more favorable than we would without the guaranty * * *."

Similar comments were made during discussions with financial experts. For example, an executive of a major Wall Street brokerage firm said that the SBA program definitely facilitates the flow of long-term money to small businesses.

7(a) guarantee permits lenders to make larger loans

Banks have successfully used the SBA guarantee to make larger loans to many businesses. Among respondents, SBA-backed loans averaged $118,000, which was about $60,000 higher than the average of the lenders' non-SBA loans.

About 43 percent of lenders said that the SBA guarantee, from a moderate to a very great extent, enabled them to make larger loans than permitted by bank policy or regulation. Smaller banks in particular found this to be a distinct benefit. All national banks have lending limits--generally about 10 percent of capital--imposed by legislation. State-supervised banks also imposed legal lending limits similar to national banks and State banks that are members of the Federal Reserve System. When the bank makes a guaranteed loan, only the unguaranteed portion counts against the limit.

Exceeding the lending limit also lets smaller banks protect their relationship with growing small businesses rather than have larger banking establishments take their business away. For example, the president of a West Virginia bank said the ability to offer SBA loans has been an important aspect of servicing the local community. He said the program affords the means of accommodating large loan requests and maintaining these businesses as customers.

The Independent Bankers Association of America also commented about the legal lending limit. In its February 1982 letter to the Senate Subcommittee on State, Justice, Commerce, and the Judiciary, the association president stated:

> "Many independent community banks across the United States participate in the SBA 7(a) program, and the handling of SBA guaranteed loans can contribute significantly to an independent bank's capacity to serve local borrowers, in two ways: (1) the guaranteed portion of an SBA loan is readily salable in secondary markets; and (2) the guaranteed portion of the loan does not apply against the individual legal lending limit of the bank and therefore the bank is able to make larger loans to individual borrowers when a guarantee is affixed."

There are indications that the SBA loan size may even be too low. About 28 percent of lenders believe that the SBA guarantee limit should be increased from the current $500,000, which was established in 1976, to a suggested average of about $900,000. Over 65 percent of larger lenders believed the loan size should be increased.

In October 1982 the Small Business Committee on Capital Access, formed by SBA in June 1982, recommended that the guarantee loan level be increased to $1 million. The committee believes that the extended period of inflation that was experienced made the $500,000 ceiling no longer reasonable for a large portion of the small business community. The committee also felt that raising the loan limit would help smaller banks meet the needs of their small business customers without having to seek help from larger financial institutions and risk losing their customers to the larger banks.

Our review of SBA loans approved in fiscal years 1979-81 showed a slight increase, from 9.4 percent to 11.0 percent, in loans between $300,000 and $500,000. While this percentage is relatively small, banks provided examples of small businesses needing more than a $500,000 guarantee. For instance, one bank described cases where to meet its small business customers' needs for loans of $1 million or more it used the 7(a) guarantee program in combination with the Farmers Home Administration's (FmHA's) Business and Industrial Loan Program. In another case, we found that a bank, in cooperation with a local development company, satisfied a small business' financial assistance needs through two loan guarantees that were about $500,000 each. These guarantees were approved under section 7(a) and SBA's section 502 Local Development Company Program. SBA's procedures state that a loan made through section 502 can supplement a section 7(a) loan. What remains unknown is how many lenders use these programs in this way or how many small businesses needing larger loans are denied credit because of the 7(a) program's $500,000 ceiling.

Lenders' reactions to reducing 7(a) guarantee percentage

Historically, the vast majority of SBA loans have been approved at the 90-percent level. In fact, Public Law 97-35, dated August 13, 1981, requires that loans under $100,000 be guaranteed at 90 percent. We asked lenders to comment on how reduced percentages in the guarantee rate would affect the number, maturity period, and size of SBA loans approved. The following depicts lender comments.

Impact of Reducing Percent of SBA Guarantee
(Percent of Responses in Each Category)

	80% Guarantee					70% Guarantee					60% Guarantee				
	Greatly increase	Somewhat increase	Remain about the same	Somewhat decrease	Greatly decrease	Greatly increase	Somewhat increase	Remain about the same	Somewhat decrease	Greatly decrease	Greatly increase	Somewhat increase	Remain about the same	Somewhat decrease	Greatly decrease
	1	2	3	4	5	1	2	3	4	5	1	2	3	4	5
1. Number SBA loans approved	2	4	58	29	7	–	1	23	48	28	–	–	18	18	64
2. Maturity period of SBA loans	1	7	66	18	8	–	2	39	35	24	1	1	31	19	48
3. SBA loan size	1	6	65	20	8	–	2	35	39	24	–	2	27	17	54

The table shows that a reduction in guarantee authority to 80 percent would not dramatically affect conditions of overall lender participation. However, a reduction to the 70- or 60-percent range has a much more visible effect. A separate analysis not reflected in the above table showed that smaller banks were more willing to accept a smaller guarantee than larger banks. For example, at the 80-percent guarantee level about 70 percent of smaller banks said their participation in the above three categories would not be affected. Conversely, only about 50 percent of larger banks indicated that their participation would remain about the same.

We did not ask banks to comment on whether a reduction in the guarantee percentage would affect one category of borrower more than others. However, it is possible that because banks would have more at risk, marginal borrowers would be more likely to be declined loans or to receive less favorable terms.

SMALLER 7(a) LOAN PROGRAM PROPOSED FOR THE FUTURE

The 7(a) program went from a $3.2 billion authorization in fiscal year 1980 down to $2.3 billion for fiscal year 1982. Administration budget submissions propose further reductions in the program's size for future years. Budget submissions estimate the 7(a) loan guarantee level in fiscal years 1983 and 1984 at about $1.9 billion. Other budget projections show the program decreasing to a level of about $1.1 billion by fiscal year 1987. The impact of these reductions cannot be fully assessed because data on program demand has not been incorporated into the budget process.

Implications of proposed
7(a) program reductions

The administration believes that a smaller 7(a) loan program will not have a significant adverse effect on small business. However, data on the demand for 7(a) assistance that considers existing and forecasted economic conditions has not been accumulated for use in the budget process. Without such data, it is difficult for the Congress or the administration to establish a funding level for the program. For example, a senior official in SBA's budget office said that the prior administration had projected increasing the 7(a) program up to a $10 billion authorization. Obtaining adequate data on the demand for 7(a) assistance would assist the administration and the Congress in deciding how large the 7(a) program should be in the context of overall Federal credit policy.

The administration's rationale for reducing the 7(a) loan program includes:

--An overall plan to control Federal credit with the 7(a) loan program as an integral component. The administration's position is that Federal and federally assisted borrowing crowds out funds needed by the private sector, including small business, and results in higher interest rates.

--An estimation that less than 1 percent of small businesses are assisted by 7(a) loan guarantees.

The President's 1982 report entitled "The State of Small Business" indicates that it is difficult to draw concrete conclusions about the impact of Federal credit assistance on the capital market or on small business. Because the 7(a) Loan Guarantee Program is such a small part of overall Federal and private sector credit assistance, its impact on interest rates and capital flows cannot be precisely isolated.

To develop some insight on the program's impact on the capital market, we asked banks to comment on how the 7(a) guarantee program influences their credit extension to other small businesses. Lenders responding to our questionnaire do

not believe the 7(a) program causes them to increase their interest rates or to exclude other small business borrowers from obtaining credit. The following table summarizes lender responses:

Impact on other borrowers	Moderate to very great extent	Some extent	Little or no extent
	(percent of responses in each category)		
Increases interest rates for other small business borrowers	4	2	94
Crowds out other small business borrowers	3	2	95

The administration's statement that the program serves only a handful of small businesses does not recognize the program's role in meeting small businesses' need for long-term financing. We found that the program provides a large percentage of the longer term and larger size loans that small businesses receive from commercial banks.

Lenders believe the program is not causing higher interest rates for other small business borrowers

According to lender perceptions, the program is not causing other borrowers to incur higher interest rates. Ninety-four percent of lenders reported that credit extension under the 7(a) loan program increased interest rates for other small business borrowers to little or no extent. Lender responses showed that interest rates charged to SBA borrowers averaged prime plus 1.48 percent whereas other borrowers were charged an average interest rate of prime plus 1.43 percent. We analyzed the Federal Reserve System's Survey of Terms of Bank Lending reports for the 3-year period 1979-81 in an attempt to substantiate the responses we received from banks. The report is a spot check of randomly selected lending institutions. While data limitations precluded us from precisely verifying the questionnaire results, the patterns for the past 3 years showed interest rates on SBA-guaranteed loans to be generally within the range of effective interest rate averages charged on all commercial and industrial loans of comparable size, even though most SBA loans are for longer terms and have higher risks.

The 7(a) loan program--unlike a number of other Federal programs--does not have fixed interest rates established by legislation. The program allows lenders to charge borrowers prevailing interest rates and to adjust interest rates according to market variances.

The extension of a 7(a) loan guarantee represents a "vote of confidence" by the Government that the small business borrower can repay the loan. Federal outlays in the program occur in those instances when borrowers fail to repay the loan and recoveries to the Government from asset liquidation fall short of meeting the Government's payout in honoring the guarantee. For example, according to SBA statistics through fiscal year 1981, losses incurred for the 7(a) program were about $700 million, or about 4-percent of approved guaranteed loans.

Program gives small businesses access to long-term credit market

According to responding lenders, the 7(a) program has not crowded out other small business borrowers. Ninety-five percent of lenders said that the 7(a) program had little or no effect on credit extension to other small business borrowers.

SBA-guaranteed loans can be sold by banks in the secondary market. By doing so banks can gain access to private capital resources traditionally not within direct reach of small businesses, which essentially results in a "redistribution" of credit. The additional financing obtained from secondary market sales can be recycled to other borrowers, including small businesses. Comments from several banks follow.

From a South Carolina bank:

> "Instead of contributing to distortion of private capital markets, the SBA 7(a) program has resulted in increased credit availability for a major segment of the nation's business community * * *."

From a Connecticut bank:

> "* * * I suppose to the extent the money loaned in these situations would have been available elsewhere (i.e., investor money not bank money) the distortion concept holds. However, if the program is administered properly, the distortion (crowding out) is temporary while the long-term impact is to create more capital, jobs, and taxes * * *."

The administration argues that Federal credit programs give a segment of borrowers preferences over other borrowers. "Crowding out" occurs when the total supply of credit is unchanged and giving credit to one borrower reduces the availability of credit for others.

In a sense, the 7(a) program helps overcome discrimination and imperfections in the capital market and makes a small business a better competitor for commercial financing than the business would be without the guarantee. The salability of the guaranteed loan helps small business to compete with government, big business, and foreign companies for institutional investment dollars. The absence of a 7(a) loan program would result in many small businesses not getting long-term credit. As mentioned on page 18, according to lender responses about 82 percent of the borrowers would not qualify for a loan without the SBA guarantee or would qualify but with different terms, such as shorter maturities, higher interest rates, or smaller loan amounts.

An economist and professor from Washington State University, testifying before the House Committee on Small Business in March 1982, argued that now is not the time to cut the SBA loan program. In an April 1982 article published in "Managing: the Entrepreneur's Guide to Success," he stated:

> "The traditional economic argument is that in a perfect capital marketplace, whoever is crowded out of the market should be crowded out of the market. Those with the best use should get the money. But we do not have a perfect capital market or perfect competition. As a result, we should ask who does a recession, caused by tight Federal money policies and a very high Federal deficit, hurt and should this impact be offset? The problem is basically government interference in the marketplace. The question is how should we offset that interference. The guaranteed loan program is an easy way to counteract these policies. The money comes out of the private sector. It is just a reallocation of capital."

A major brokerage firm executive on Wall Street pointed to the need for a viable loan guarantee program. He told us that, unfortunately, all industry is not created equal nor does all industry have an equal access to capital. Medium- and large-size firms have more options for obtaining funds. For instance,

a large firm can go to a private investor, such as an insurance company, and place a long-term debt issue. A large firm can also offer a stock issue or draw financing from a bank. In contrast, a small business has fewer options--a primary option being bank borrowing. The 7(a) program can help viable small businesses get the long-term debt financing that banks would be unwilling to finance without the protection of a Federal guarantee and makes them more equal with big business.

An executive of a major investment bank told us that he generally was not a believer in the proliferation of Government guarantee programs. However, he believes there is a void in the capital markets relating to small business and that it is appropriate for the Government to operate a business loan guarantee program similar to SBA's 7(a) program.

Lastly, a bank representative on the Small Business Committee on Capital Access made this statement:

> "At the outset, let us recognize that Government guarantees on loans to small business distort or bias the operations of credit markets. In my mind, I justify this intrusion because of regulation of financial industries, tax policy and an array of other Governmental activities currently bias credit markets to the detriment of small business. The 7(a) program has the potential to provide equity to small business in competing for access to capital markets * * *."

<u>Program is assisting a significant segment of small business</u>

Our survey indicates that the 7(a) loan program benefits an important segment of small businesses in need of long-term debt financing. However, the program's significance has been downplayed by the administration's estimate that less than 1-percent of small businesses receive any type of financial assistance from SBA.

The administration is correct in stating that less than one percent of the roughly 11 million small businesses are assisted in any year by an SBA-guaranteed loan. However, in our opinion a more meaningful assessment of the program's value is to compare the number of small businesses needing long-term financing and how much of this financing is provided through SBA-guaranteed loans. Unfortunately, data is not available on the number of small businesses that need long-term credit in any given year, but it is certainly much less than the 11 million small businesses. In fact, Dun and Bradstreet's September 1979 market identifier record shows that only about 4.5 million firms had applied for credit at some time in their history.

Recognizing that a large segment of small businesses never apply for credit, we attempted to establish parameters on the extent commercial banks are using the SBA guarantee program to meet small businesses' long-term debt requirements. Bank responses to our questionnaire show that approximately 13 percent of the total amount of banks' outstanding small business loans had an SBA guarantee. This percentage increases substantially if we only consider banks' long-term small business lending.

Our analysis of questionnaire responses indicates that approximately 30 to 40 percent of the dollar amount of banks' long-term financing (6 or more years) to small businesses may carry an SBA guarantee. This estimate is based on lender responses that distinguished the different maturities on SBA-guaranteed loans and nonguaranteed loans. The estimate also takes into account the sampling error discussed in appendix II.

We recognize that our estimate only applies to the 8,900 banks that participated in the program during fiscal years 1979-81. These banks represent approximately 60 percent of all commercial banks. To the extent that banks not participating in the SBA guarantee program also make long-term loans to small businesses, our 30- to 40-percent estimate would be lowered. While our estimate is not precise, it is a measure of the value of the SBA guarantee program that contrasts with the administration's statement that less than 1 percent of small businesses are served by the program.

Aside from satisfying a significant portion of small businesses' long-term capital needs, the SBA guarantee also provides larger loans than banks normally provide to small businesses. As mentioned on page 23, the average SBA loan was $118,000, or $60,000 higher than other small business loans.

Additional data needed to properly evaluate forecasted reductions in the 7(a) program

The administration has not fully assessed the impact of forecasted reductions in the 7(a) program on small businesses' ability to obtain long-term debt capital. Without such an assessment, both the administration and the Congress are hampered in determining the funding level for the program. We believe that SBA could better ensure that policymakers in the Congress and the administration are apprised of probable impacts of varying funding levels by forecasting demand for the program as part of the budget process.

The House Committee on Small Business also recognized the need for data on program demand. Accordingly, it included a provision in H.R. 6086 that would have required SBA to keep records for 1 year on all names, addresses, telephone numbers, and amounts requested by loan applicants or those who inquire about loan availability.

Although the provision was not enacted into law, SBA recently took action to carry out its intent. Specifically, SBA modified its management information system so that information on the status of loan applications is available to its central office. This information is being kept for 1 year as the provision would have required. SBA officials told us, however, that they do not plan to collect information on inquiries because they have no way of knowing whether the inquiries represent actual demand for the program unless they result in applications. We were also told that the collection and reporting of data on loan inquiries would be time consuming and detract from other priorities of district office staff.

SBA's efforts to improve the availability of data on loan applications provide a basis to monitor demand for the program. The data should be incorporated in the budget process together with forecasts of changes in economic activity that could increase or decrease program demand. This information would assist the administration and the Congress in determining the program's proper size.

GREATER EMPHASIS GIVEN TO REDUCING 7(a) LOAN LOSSES

High 7(a) loan losses can be reduced if SBA emphasizes the credit quality of borrowers. However, SBA needs to see whether its loan quality standards are clear and are being applied consistently throughout its field offices.

According to SBA records the loss rate for 7(a) loans through fiscal year 1981 was about 4 percent. Loss rates have been steadily increasing, and SBA projects that additional losses on loans made through fiscal year 1981 will result in a final loss rate of about 10 percent. These losses are high when measured against overall bank loss rates, which run about 1 percent of total dollars loaned. However, lenders use the guarantee to finance new business ventures which carry a greater risk of borrower default. About 52 percent of non-SBA financing is for maturities of 1 year or less. Much of this financing is for revolving lines-of-credit to established small businesses which also involves less risk than SBA's long-term financing that usually has maturities of 6 or more years.

SBA's loan losses have been significant because the agency tended to measure its performance on the basis of getting increasing numbers of 7(a) loans approved. A June 1982 memo from SBA's Associate Administrator for Finance and Investment to the heads of SBA field offices pointed out that short-cut processing methods evolved because of the large number of loan applications to be handled. These methods led to loan approvals for less qualified or even unqualified applicants. These practices, which are costly to the agency, are also unfair to small business borrowers who are unable to repay the loan.

SBA has taken steps to reduce loan defaults by improving the quality of loan decisions. The borrower's credit quality and the adequacy of the loan officer's analysis of the credit will be more closely assessed. SBA needs to be cautious, however, that demand for its loans is not dampened because of inconsistent application of credit standards among SBA field offices.

SBA recognizes that problems can arise with the policy shift toward quality lending. For example, the June 1982 memo from the Associate Administrator states:

> "Recently, we have experienced an increasing number of questions on the subject of quality loans both from our own personnel, and from participating lenders. The questions from our participants seem to arise primarily from varying explanations among district offices and from the application of varying standards and practices in loan processing among district offices."

The memo goes on to state that improvements in assessing credit quality cannot or should not be accomplished by imposing rigid credit requirements. Rather the memo provides the following guidance on a quality loan:

> "* * * a quality loan is an eligible small business loan that has reasonable assurance of repayment in the judgment of a trained, experienced, and qualified loan officer who has adequately and professionally assessed the risks involved in accordance with established credit principles."

The impact on small business lending resulting from SBA's shift to quality lending was generally outside the scope of this review. However, several optional comments made by lenders to our questionnaire and higher rejections of loan applications at district offices we visited raise our concern that quality could

be overemphasized to the point that small businesses with reasonable risks are denied funding. The following are two interesting comments from lenders concerning quality loan approval.

From a Kentucky bank:

"Over the past few months as a participant in the SBA Bank Certification Program, we have found it increasingly difficult to get loans approved through our local SBA office. Stringent credit, collateral, and capitalization requirements recently imposed by the SBA make it nearly impossible for the small business person to expand or get started in business. The recent requirement of a debt to worth ratio of no greater than 3 to 1 in addition to increasingly strict collateral coverage requirements appear to be an effort on the part of the SBA to impose the same credit qualifications normally imposed by commercial banks.

"While we understand that high interest rates and the depressed economy require us all to take a more conservative look at any loan request, we also believe that good opportunities for new business and increased employment are being passed over due to the SBA's rigid rules and lack of flexibility in structuring good loans."

From a Pennsylvania bank:

"SBA has consistently declined submitted loans for the reason that it was submitted [by the bank] in the first place. For example, if the bank felt cash flow was tight and submitted the loan to SBA for a guarantee because of that, they would turn it down because of the poor cash flow."

The increased emphasis on loan quality has resulted in higher rejections on loan applications. Discussions with district office officials and review of district office records showed a higher incidence of loan rejections. For example:

--Chicago rejections were running at 50 percent compared with 40 percent for earlier years.

--Madison rejections were at 60 percent, whereas only 30 percent were rejected before tighter credit policies were implemented.

--Indianapolis district officials said loan rejections were up but had no figures.

--Columbus district records showed that 14 more applications were received in fiscal year 1982 but 43 less were approved.

The Clarksburg district office received 243 less applications during fiscal year 1982 than fiscal year 1981. Although we did not obtain statistics on loan approvals, the district director told us that his district initially over-reacted to headquarters' requirement for better loan quality and went from the highest to the lowest lender in the region.

Officials in the districts visited stressed that increased emphasis on quality loans was informal and no written instruction had been issued. In contrast, the San Francisco district office issued a detailed matrix guide to rate both the quality of the loans as well as the quality of the loan officer's review.

Different approaches used by district offices to ensure loan quality could lead to inconsistent loan decisions if loan quality is emphasized more in one district than in another. In fact, SBA's Deputy Associate Administrator for Financial Assistance advised us that he was aware of one region that applied stricter standards than SBA headquarters intended.

CONCLUSIONS

A healthy small business sector helps reduce the Nation's high unemployment. SBA's 7(a) loan program fills a worthwhile niche in assisting many new and existing small businesses meet their credit needs and thereby provide jobs.

Lenders indicated that the 7(a) program has several important advantages. It allows them to make long-term loans to small businesses that would not be made without the guarantee. Lenders also commented that the guarantee enables them to finance new business ventures that lack a track record and to make larger loans than their lending limits permit. Additionally, the program extends credit at interest rates comparable to rates paid by other small business borrowers even though most loans have longer maturities and a higher degree of risk. Lastly, it helps expand available credit to small businesses and others by letting lenders sell the loans to investors.

Lenders do not perceive the program as causing increased interest rates or excluding other small business borrowers from their local credit market. Also, the impact of the 7(a) loan program is significant in terms of satisfying small businesses' long-term capital needs.

Lenders had different perceptions about whether SBA's current loan limit of $500,000 should be raised to satisfy some businesses' capital needs. Although only 28 percent of lenders overall believed the level should be raised to a suggested average of about $900,000, over 65 percent of large lenders saw a need for the higher loan limit. Accordingly, we suggest that any future deliberation on raising the limit obtain the views of lenders, especially large lenders. These lenders could provide insight into the types of businesses and investment needs that larger loan guarantees would satisfy.

Any increase in the current loan limit would likely result in fewer loans being made, assuming a stable loan guarantee authority. Conversely, reducing the guarantee percent from 90 to 80 would stretch 7(a) financing, allowing more loans to be made. Although lenders generally indicated a willingness to participate in the 7(a) program at the 80-percent guarantee level, it is possible that this could have some adverse effect on marginal borrowers.

Admittedly, loan losses are higher than normal lender standards, and greater emphasis should be placed on getting losses into more acceptable ranges. However, SBA must assure that loan quality standards are sufficiently clear and consistently followed by it field offices. This assurance should help qualified borrowers from being denied credit. Attention to this matter is important since lenders and a senior SBA official have expressed concerns that quality standards may have been overemphasized in certain locations.

Data is lacking on the actual demand for 7(a) loan assistance, and it is difficult to determine how large or small the 7(a) program should be. This data would help the Congress and the administration decide the proper size of the program in the context of overall Federal credit policy.

RECOMMENDATIONS

We recommend that the Administrator, SBA:

--Evaluate district office implementation of loan quality standards to see whether they are clear and applied consistently throughout SBA so that individual borrowers, who satisfy SBA's quality standards, are not denied credit.

--Accumulate data on 7(a) loan applications, approvals, and rejections and use this data, together with data on forecasted

economic activity, to project future demand for 7(a) assistance. Activity data on applications, approvals, and rejections should also be used to monitor the consistent application of loan quality standards in SBA offices.

MATTER FOR CONSIDERATION BY THE SENATE AND HOUSE COMMITTEES ON SMALL BUSINESS

We suggest that the committees propose legislation requiring SBA to accumulate and integrate loan demand data into future budget proposals for the 7(a) loan program. This data, based on past and forecasted economic conditions, would give the committees a better basis for deciding future program authorization levels in the context of overall Federal credit policy.

AGENCY COMMENTS

SBA basically agreed with our recommendations and the matter raised for congressional consideration. SBA said that the material presented would prove very helpful in considering policy alternatives for the 7(a) Loan Guarantee Program.

CHAPTER 3

SBA'S SECONDARY MARKET PROCESS

HELPS LENDERS FINANCE SMALL

BUSINESSES BUT CAN BE IMPROVED

Sales of SBA-guaranteed loans in the secondary market benefit small businesses. Lenders are able to obtain funds from investors such as insurance companies, pension funds, and money market funds which traditionally do not invest directly in small businesses. For some small banks, being able to gain access to these pools of managed capital is the difference between being able or unable to make an SBA-guaranteed loan. The secondary market process also has a leveraging effect, allowing lenders to reinvest the proceeds from sales in other small businesses. Lastly, the secondary market is used by some lenders to offer borrowers (1) the stability of fixed rate instead of variable rate loans and (2) lower interest rates.

However, the process is not without its problems. It operates without formal goals and objectives, and management responsibilities for its oversight are not clearly defined. Furthermore, lenders are making limited use of it, which minimizes its help to small businesses. While some lenders are using the secondary market to offer borrowers lower interest rates, others are making substantial profits on their secondary market sales without passing lower rates on to their customers. Finally, two technical problems with the secondary market process are (1) the reporting system does not provide management with accurate data on secondary market transactions and (2) the accounting procedures are not standardized, which causes recordkeeping problems that are particularly troublesome to investors.

Improvements can be made to the secondary market process that should help minimize the problems noted and possibly lead to greater lender participation. SBA's Small Business Committee on Capital Access identified several of the same problems, and we have considered their conclusions and recommendations in this chapter.

LENDERS AND SMALL BUSINESSES BENEFIT FROM SECONDARY MARKET

The secondary market is used by lenders to make loans they would be unable to make otherwise because of limited capital. Lenders also recycle funds from secondary market sales to make more loans to small businesses. Finally, the market is used by some lenders to make fixed rate loans.

We met with officials of three of the four nonbank lenders. Two told us that their policy is to use the secondary market to the maximum by selling most of their guaranteed loans. They said that the secondary market enables them to leverage their funds and make many more loans than their capital would otherwise allow. They specifically noted that small businesses have a pressing need for long-term debt capital that they can only satisfy by selling loans in the secondary market. The other nonbank lender we contacted told us it had also used the secondary market for the same reasons but stopped selling loans in 1982 because it had sufficient liquidity to respond to loan demand. The fourth nonbank lender is no longer active in the program and was not contacted.

A number of banks have also decided to use the secondary market to expand their small business lending as nonbank lenders have. We visited a bank in Pennsylvania and were told by a lending official that the secondary market enabled his bank to significantly increase its small business lending. This bank made 54 SBA-guaranteed loans totaling $7.8 million in fiscal years 1980-81. Sixteen of these loans were sold in the secondary market.

A large SBA lender in Idaho--making about $27 million in 7(a) guaranteed loans in 1 year--commented that the guarantee combined with the secondary market enables it to recycle its funds and make many more loans. The bank president said his bank is located in a capital poor area where loan demand outstrips the availability of capital. He said that SBA's loan guarantee program together with the secondary market overcomes this problem.

We also visited a Wisconsin bank that has used Government-guaranteed loan programs and the secondary market extensively. As of August 1982 about $47.6 million of the bank's nearly $100 million commercial loan portfolio was guaranteed by either SBA or FmHA.

According to the bank president and other senior officers, the bank has a very aggressive small business lending policy. They said the bank's involvement with the SBA and FmHA loan programs and the secondary market is to provide long-term financing to small businesses. The officials explained that long-term assets such as buildings and equipment ideally should be financed on a long-term fixed rate basis. This principle is used by large businesses that are able to sell bond or stock issues to obtain long-term financing. However, this approach often is not available to small businesses that normally must obtain their financing from the local commercial bank. As discussed in chapter 2, banks are restricted in making long-term fixed rate loans partly because bank deposits are short-term in nature and a bank does not want to create a long-term asset (a loan) when its liabilities (deposits) are short term.

According to bank officials, the Government guarantee combined with selling loans in the secondary market overcomes the problem of matching the terms of a loan to the bank's deposits. This enables them to provide long-term fixed rate financing, which in the bank president's words, "impacts very favorably on the cash flow and debt service requirements of small businesses."

The bank president estimated that the SBA program enabled it to make about $30 million in loans that it probably would not have made. Also, without the program bank officials said small business borrowers would be restricted to 3- to 5-year financing. According to information supplied, the bank had almost $25 million in outstanding SBA loans including $13.9 million in fixed rate loans. Its average SBA loan had a term of 11.6 years.

For nonbank lenders and banks that actively sell their SBA-guaranteed loans, the benefit of using loan proceeds from secondary market sales to make other small business loans is fairly visible. For the majority of lenders that sell only a few loans, this benefit is less visible. However, a consultant to the Interagency Task Force on Small Business Finance told us that it is fair to assume that the proceeds from selling SBA loans are used to finance other small businesses in about the same proportion that small business loans are represented in the lenders' portfolio. During fiscal years 1979-81, about $1.5 billion in loans was sold in the secondary market. Responses to our questionnaire show that small business loans account for an average of about 27 percent of lenders' portfolios. Under the above assumption, a potential of $400 million may have been recycled to small businesses. This is particularly important because these additional funds are made available from investors, such as pension funds and insurance companies, that do not typically invest directly in small businesses.

The secondary market helps some borrowers obtain fixed rate loans

Between November 1979 and July 1982 interest rates were not only very high but also fluctuated considerably. (See p. 78.) This caused problems both for lenders and borrowers. It was a problem for lenders because they risked making a loan at a rate that may quickly be below market rates or even their own cost of funds. To protect themselves against this situation, many lenders chose to make variable rate instead of fixed rate loans with the interest rate set to vary with the prime rate. This strategy protects the lender, but when interest rates rise significantly the borrower's costs increase correspondingly.

Liquidity and leveraging advantages

The secondary market process has advantages for both lenders and small businesses:

--It helps lenders with liquidity problems to make loans to small businesses that otherwise would not be made.

--It enables lenders to leverage capital and make more small business loans than otherwise would be possible.

Because the lender can sell the guaranteed portion, it can make the loan with the assurance that it can recoup 90 percent of its funds to satisfy other capital requirements.

Not surprisingly, the issue of liquidity becomes increasingly important as banks get smaller. About 54 percent of the responding small banks in our sample that use the secondary market indicated that to a great extent liquidity was the factor that caused them to sell. In contrast, only 17 percent of the responding large banks that sold loans in the secondary market indicated that liquidity was a factor to any great extent.

A number of small banks commented about the advantages of the secondary market in solving their liquidity problems. Sources of comments included (1) responses to our questionnaire, (2) responses to SBA's July 1981 proposal to limit allowable interest rates, and (3) responses obtained through conversations with lenders.

From a Texas bank:

"SBA loans can be justified by the opportunities offered through the secondary market. A bank can make long term loans, sell the guaranteed portion, maintain liquidity and recycle proceeds from the sale to the benefit of local business. The longer terms that can be offered local business with SBA loans permit smaller payments, better cash flow management and improved liquidity."

From a Minnesota bank:

"The secondary market has provided increased liquidity, particularly for community banks, but for all banks in general, by creating the availability to sell portions of their SBA loan portfolio. By making use of the secondary market facilities that exist, banks can be sure that

their credit-worthy small business customers continue to have loan funds available to them at all times."

Aside from helping with actual liquidity problems, the secondary market offers lenders a hedge against future liquidity problems. Over 20 percent of the responding small banks said that to a great extent they use the secondary market in this manner. A Wisconsin bank's comments graphically illustrate this use.

"During January of 1980, a Milwaukee company had an opportunity to increase sales by almost $4.5 million over the prior years sales of $5.5 million by taking on [a major project] in San Francisco. This required a substantial increase in credit for working capital and equipment. The business had been with one of the largest banks in Wisconsin for over 20 years with a very favorable credit history. In January, 1980 however, the company was told by its bank that money was tight and they couldn't allocate the needed funds. Our bank took over the account and provided a $500,000 loan guaranteed by S.B.A. and an unguaranteed line of credit of $350,000 to pay off loans at the former bank. We were able to do that at a time when our loan to deposit ratio was already high, because we knew we could sell the guaranteed portion if we encountered a liquidity problem. We never actually sold the loan because we could tolerate higher loan levels by virtue of the ability to sell."

Through leveraging, the lender basically uses someone else's money--the investor's--to make additional loans. The most active sellers of SBA loans are not banks but what SBA refers to as nonbank lenders. Nonbank lenders include financial corporations that make SBA-guaranteed loans provided they meet certain qualifications. Specifically, SBA requires that nonbank lenders solely engage in making SBA loans, have paid-in-capital and surplus of not less than $500,000, and accept SBA supervision. Through fiscal year 1981 there were four approved nonbank lenders. In January 1982 SBA stopped approving nonbank lenders because it does not have the resources to service and effectively supervise their activities.

Nonbank lenders have been much more active users of the secondary market than banks. For example, almost 80 percent of the loans made by nonbank lenders were sold, but less than 20 percent of the loans made by banks were sold.

When interest rates go up dramatically, variable rate loans can prove disastrous to the cash flow of small businesses. A recent report by the House Committee on Small Business contained examples of the effect of rapidly rising interest rates on small businesses. In one case, a small business' monthly loan payment increased from $3,018 to $4,583. In another case, the small business' monthly payment increased from $5,640 to $8,935--an increase which represented, on an annualized basis, about one-third of the company's previous year's net profits.

Variable rate loans also cause problems for SBA in its credit analysis. For example, a key element of SBA's approval process is evaluating the borrower's ability to repay the loan. Use of variable rate loans with highly volatile interest rates during much of 1980 and 1981 made assessing repayment capability difficult.

Because of the problems that variable rate lending causes small businesses during periods of volatile interest rates, several lenders have used the secondary market to make fixed rate loans which allows the borrower to budget for interest costs more accurately. Lenders can offer borrowers fixed rate financing often by arranging forward pricing commitments with investors. Generally under a forward pricing arrangement the investor agrees to purchase the loan at a specified rate if delivered within a certain period--usually about 45 to 60 days.

Several banks commented on the use of such an arrangement. For example, a Texas bank stated that, "It has helped us give fixed rates if we knew in advance we could sell the loan." This sentiment was echoed by a Vermont bank who told us, "By pre-selling the loan in a secondary market, we are able to offer customers a fixed-rate during these volatile times * * *." A bank we visited in Pennsylvania told us that it would offer borrowers fixed rate financing if forward pricing commitments with investors could be arranged. By doing this, the bank would be able to know its yield and price loans accordingly and the borrower would have fixed rate financing and be able to budget interest costs accurately.

Other lenders, while not commenting on whether they obtained forward pricing commitments, did point out how the secondary market helps them make fixed rate loans. For example, a banker in Delaware told us his bank is willing to make fixed rate loans in certain cases because the loan can be sold in the secondary market. He said fixed rate loans are made to borrowers whose cash flow might be impaired if a variable rate loan were used. The Senior Vice President of an Indiana bank told us that one of the attractive features of the 7(a) program in conjunction with the secondary market is that it allows the bank to offer small business borrowers fixed rate loans.

While some lenders have been fairly active in making fixed rate loans, we believe the secondary market offers the potential of making more of these loans available. (See p. 56 for a more detailed discussion.)

SBA SHOULD CLARIFY ADMINISTRATIVE RESPONSIBILITIES AND OBJECTIVES FOR THE SECONDARY MARKET

SBA has taken several initiatives to improve the secondary market process. These include establishing an Office of Secondary Market Operations in New York and contracting with a fiscal transfer agent. Also, the present SBA Administrator in the summer of 1982 created the Small Business Committee on Capital Access largely for the purpose of recommending ways to enlarge the supply of funds made available to small business while reducing the cost of these funds.

Although these are positive actions, SBA still does not have specific goals and objectives for the secondary market process and clear lines of authority and responsibility for its oversight have not been established. Our discussions with SBA officials showed that the lack of objectives and lines of authority and responsibility has caused confusion over (1) who is responsible for different administrative functions and (2) what the secondary market process can and should accomplish.

The Office of Secondary Market Operations is staffed with two people--a director and associate director--whose primary responsibilities, according to their job descriptions, include

--maintaining continuing liaison with financial institutions to promote and further develop a national secondary market in SBA-guaranteed loans,

--coordinating the field office secondary market program, and

--evaluating the secondary market program in all regions.

Aside from these job descriptions very little documentation exists on administrative responsibilities of SBA staff outside New York for the secondary market. In fact, SBA officials, both in New York and at SBA headquarters, cited only the following references to the secondary market. First, the Code of Federal Regulations (13 CFR 101.2-7d dated Jan. 1, 1982) states that the Investment Division "plans, directs and administers the secondary market liaison function." A senior official within the Investment Division stated that he was unclear as to what this liaison function actually meant or how it was to be implemented.

The second reference, published in the Federal Register on April 7, 1982, delegates general authority for the secondary market to the Associate Administrator for Finance and Investment. Among other things, the Associate Administrator is responsible for (1) developing policies and procedures and for directing all aspects of the secondary market and (2) determining and developing policies and procedures necessary for field support of secondary market activities.

With the exception of detailed procedures to field offices on the mechanics of processing a secondary market transaction, there are no procedures specifying the functional responsibilities of either the Investment Division or the Financial Assistance Division. While staff in both divisions are involved with the secondary market, our conversations with officials disclosed a general uncertainty over what the process was expected to achieve and exactly what was expected of them. One official characterized the secondary market as an "orphan" in SBA because of the uncertainty over what the process is intended to accomplish and who is responsible for determining whether it is meeting its objectives.

The final reference to the secondary market appears in SBA standard operating procedures (50-50-2) and discusses field office responsibilities for processing and closing secondary market transactions. As stated above, these procedures are detailed. However, our visits to several SBA field offices revealed that they are not always followed. For example, the procedures require that before a loan is sold a transcript showing that the loan is current is to be furnished by the lender to SBA. This requirement is to protect the investor from purchasing a problem loan. This procedure was not followed in one of the six districts we visited; but more importantly, no one is specifically assigned responsibility outside the districts to oversee compliance. Likewise, while districts are required to submit monthly logs on loans sold, many are incomplete or not submitted at all. (See p. 62.) Again, responsibility to oversee compliance is not specifically assigned outside the district office.

Ambiguities over functional responsibilities are in our judgment at least partly attributable to the lack of specific goals and objectives for the secondary market process. There was unanimous agreement among the Director of the Office of Secondary Market Operations and officials at SBA headquarters that formal goals and objectives, with procedures for achieving them, should be established. This need is critical not only from the standpoint of guiding overall agency policy regarding the secondary market but also for clarifying which organizational components will be responsible for implementing and overseeing that these goals are achieved.

Reorganizations within SBA over the past several years were cited by SBA officials as a major reason for the lack of clear responsibilities and specific objectives for the secondary market. We were told by SBA management that procedures are being developed that will specify the responsibilities of the different organizational units within SBA for the secondary market. To the extent these procedures also lay out specific goals and objectives and address other problems discussed in the remainder of this chapter, the secondary market process will be improved.

IMPACT OF SECONDARY MARKET IS LIMITED BECAUSE MANY BANKS DO NOT USE IT

Even though a number of incentives exist for using the secondary market, the vast majority of loans are not sold. The following SBA statistics show that less than 19 percent of loans approved in any fiscal year since 1977 were sold. Because the number of loans approved include a small percentage of economic opportunity loans, which are also eligible for sale in the secondary market, the figures are slightly higher than shown in the table on page 4.

Fiscal year	Number of loans approved	Number of loans sold	Percent
1977	25,031	2,671	10.7
1978	25,485	3,875	15.2
1979	23,779	3,904	16.4
1980	24,786	2,942	11.9
1981	22,880	3,022	a/13.2
1982	12,231	2,320	18.9

a/The accuracy of SBA's statistics for loans sold in fiscal year 1981 was verified. We found that actual sales were about 19 percent higher than reported, or about 16 percent for the fiscal year. The reporting problems are discussed more fully on p. 62.

Even if other fiscal years' activity were adjusted to account for the error rates noted in fiscal year 1981, loans sold in the secondary market probably would still have not exceeded 25 percent in any given year. The following table identifies the reasons given by banks for not selling SBA loans.

	Major reason	Somewhat of a reason	Not a reason
	(Percent of responses in each category)		
Not that familiar with secondary market sale provisions	11	22	67
SBA loans represent small portion of our portfolio	49	27	24
Did not need liquidity	52	22	26
Insufficient yield or profit	14	18	68
Would lose deferment flexibility with the borrower because of third party interest	6	20	74
Loan guarantees are retained as "collateral"	7	18	75

As shown in the table, the most frequently cited reasons for not selling loans were that they represented only a small portion of the bank's loan portfolio and banks did not need the liquidity. For example, a bank in Louisiana stated:

> "The primary reason our bank has not sold SBA loans in the secondary market is that we have not had a liquidity problem, particularly during the past 3 years, and have not felt a need to utilize the secondary market."

About 34 percent of the banks reporting that they did not sell loans also reported lower demand for loans. Mentioned most frequently as reasons for the decreased demand were high interest rates followed by a depressed local economy. Another reason for a decreased number of loan applications was fewer new business starts.

We visited approximately 20 banks in Pennsylvania and Delaware during the last quarter of calendar year 1981 and the first quarter of 1982. Officials of most of these banks said that they were in a comparatively liquid position because high interest rates had been keeping loan demand down. Accordingly, they said they were retaining their SBA-guaranteed loans rather than selling them.

Results of our questionnaire show that many banks have not sold SBA loans in the secondary market because they represent such a small portion of the banks' loan portfolio. This is particularly the case with larger banks. Even though many of them are quite active in making SBA loans, the percent of their SBA loans to their total small business loan portfolio was about 6 percent, compared with 14 percent for small banks and 9 percent for medium-sized banks. Also, about 17 percent of the banks responded that they had less than three SBA loans. Of this group, only 7 percent sold loans, with most citing the small portion of their portfolio as the reason for not selling.

As the table on page 47 shows, other reasons offered by banks as affecting their decision not to sell SBA loans in the secondary market were (1) insufficient yield, (2) loss of the ability to adjust the borrower's payments if necessary, and (3) desire to retain the guaranteed portion of the loan as collateral.

SECONDARY MARKET'S EFFECT ON SMALL BUSINESS BORROWING COSTS

SBA expected that, over time, use of the secondary market would result in lower borrowing costs to small businesses. However, our comparison of interest rates on loans sold in the secondary market with those not sold showed no significant difference in interest rates for fiscal years 1980-81.

Using data tapes of loan information supplied by SBA and by SBA's fiscal transfer agent for the secondary market, we compared the interest rates on loans sold with the interest rates on the entire group of SBA-guaranteed loans (about 71,000) approved in fiscal years 1979, 1980, and 1981. Our comparison was limited to loans sold through the FTA because data on other loans sold was not automated and did not readily lend itself to analysis. About 40 percent of the loans were sold using the services of the FTA.

Our comparison of variable rate loans sold in the secondary market showed that they carried higher interest rates than variable rate loans not sold, as shown in the following table.

Fiscal year	Variable rate loans — Sold: Number	Sold: Average interest rate (percent)	Not sold: Number	Not sold: Average interest rate (percent)
1979	127	Prime + 2.60	a/8	Prime + 2.18
1980	571	Prime + 2.25	2,004	Prime + 2.11
1981	608	Prime + 2.28	10,057	Prime + 2.08
	1,306		12,069	

a/The small number of loans prevents a valid comparison with variable rate loans sold in fiscal year 1979.

A further analysis showed that two large nonbank lenders accounted for most of the interest rate differential, as shown in the table below.

Fiscal Year	Variable rate loans made by nonbank lenders: Number	Average interest rate (percent)	Variable rate loans made by other lenders: Number	Average interest rate (percent)
1979	3	Prime + 2.75	124	Prime + 2.60
1980	127	Prime + 2.61	444	Prime + 2.14
1981	168	Prime + 2.65	440	Prime + 2.15
	298		1,008	

Nonbank lenders generally have a policy of making the majority of SBA loans at the maximum rate of prime plus 2.75 percent. As shown by the above two tables, this practice has largely contributed to the differences in interest rates between variable rate loans sold and not sold.

The negligible difference in interest rates between loans sold and not sold in fiscal years 1980-81, after removing nonbank lenders, was further substantiated by bank responses to our questionnaire. Fifty-seven percent of the lenders indicated

that the secondary market has no effect on the interest rate, and another 25 percent said that the effect is less than 1 percent.

Fixed rate loans sold in 1979 and 1980 also had a slightly higher interest rate than those not sold. However, in 1981 the opposite happened, as shown in the next table.

	Fixed rate loans			
	Sold		Not sold	
Fiscal Year	Number	Average interest rate	Number	Average interest rate
		(percent)		(percent)
1979	658	11.8	23,052	11.5
1980	841	14.7	21,334	14.5
1981	311	16.9	11,924	17.6
	1,810		56,310	

No definitive conclusion can be reached for the differences in the above rates. However, a possible explanation given by an SBA official knowledgeable in the secondary market was that lenders in 1981 may have been more apt to hold onto their higher priced fixed rate loans anticipating that interest rates would decline.

Some lenders strive to reduce borrowers' costs; others do not

Lenders can use the secondary market to significantly increase their yields on SBA loans or to reduce borrowers' interest costs. Yields increase because investors accept a lesser rate of interest than the bank charges the borrower. This difference is called a servicing fee. Depending on the circumstances of the sale, yields can be very high, as illustrated by the following example:

--In July 1981 a Pennsylvania bank made a $100,000, 7-year variable rate loan to a grocery store. The interest rate to the borrower was prime plus 2 percent. In February 1982, when the value of the loan had been paid down to $93,827, the bank sold the 90-percent guaranteed portion of the loan, which at that time amounted to $84,444. The price the dealer paid the bank was 102.3 percent of the face amount, or $86,386 (a $1,942 premium). The interest rate the dealer accepted was prime minus 1.3 percent.

Assuming that prime averaged 13 percent between February 1982 and February 1983, the resulting 3.3 percent service fee, together with the $1,942 premium, translates to about a 60-percent return to the bank during the first year of the loan.

In contrast with the above example, some lenders pass along lower interest rates to their small business borrowers. Data maintained by the FTA showed a number of banks with comparatively low servicing fees. For example, a West Virginia bank sold six loans in fiscal year 1981 with an average servicing fee of about 1 percent. We contacted the bank president and asked him to discuss his lending policies. He said he prefers to make fixed rate loans that are presold before the loan is closed. His bank gets a 45-day forward pricing commitment from its broker for a set rate. The bank then adds a service fee of 1/2 to 1 percent to the agreed rate. The president believes that a service fee of between 1/2 and 1 percent is sufficient. He said that many banks do not do anything for the service fee except open mailed-in financial statements, make a couple of phone calls, and maybe visit once a year.

Our discussion with lenders revealed that the amount of loan servicing done varies from next to nothing to detailed involvement with the borrower. Further, the servicing fee generally does not relate to the actual amount of servicing performed by the lender and in most cases it is simply the difference between the interest rate charged the borrower and the rate at which the loan is sold in the secondary market.

For fixed rate loans the servicing fee is primarily linked to the length of time the loan is held before sale. When interest rates are rising, fixed rate loans often must be sold at a discount or not sold at all. For example, the Wisconsin bank mentioned on page 42 had almost $14 million in fixed rate loans which, according to the bank president, could not be sold, except at a discount, because of rising interest rates. Conversely, lenders can obtain high service fees on fixed rate loans when interest rates fall. The exposure of lenders to market fluctuations and market risks was a primary consideration in the Capital Access Committee's recommendation that no restrictions be placed on servicing fees for loans held longer than 6 months. (See p. 54.)

There is no current limitation on the amount of servicing fees that lenders can charge on SBA loans sold in the secondary market regardless of the time the loan is held. Computerized data on service fees is limited to the loans sold through the FTA. Analysis of this data for 3,116 loans sold in fiscal years 1979-81 showed wide variations in the service fees being charged by lenders as follows:

Service fee range	Number of loans sold			Percent of loans sold (cumulative)		
	Fixed rate	Variable rate	Total	Fixed rate	Variable rate	Total
(percent)						
Less than .50	489	40	529	27	3	17
.50 to .99	437	84	521	51	9	34
1 to 1.49	332	94	426	70	17	47
1.5 to 1.99	280	166	446	85	29	62
2.0 to 2.49	105	254	359	91	49	73
2.5 to 2.99	69	433	502	95	82	89
3.0 to 3.49	41	154	195	97	94	96
3.5 to 3.99	19	39	58	98	97	97
Over 4.0	38	42	80	100	100	100
Total	1,810	1,306	3,116			

Lenders can derive significant yields based on the servicing fee charged and the prevailing interest rate. For example, 861 loans in the above table were sold with a service fee between 2 and 3 percent. Based on interest rates between 14 and 21 percent, lender yields would range between 32 and 48 percent. The table that follows shows some typical yields that can accrue to the lender for various borrower interest rates and service fee combinations, assuming the loan is 90 percent guaranteed and sold at face value.

Borrower Interest Rate	SERVICE FEE									
	1/4	1/2	1	1 1/2	2	2 1/2	3	3 1/2	4	4 1/2
14	16.25	18.50	23.00	27.50	32.00	36.50	41.00	45.50	50.00	54.50
14 1/2	16.75	19.00	23.50	28.00	32.50	37.00	41.50	46.00	50.50	55.00
15	17.25	19.50	24.00	28.50	33.00	37.50	42.00	46.50	51.00	55.50
15 1/2	17.75	20.00	24.50	29.00	33.50	38.00	42.50	47.00	51.50	56.00
16	18.25	20.50	25.00	29.50	34.00	38.50	43.00	47.50	52.00	56.50
16 1/2	18.75	21.00	25.50	30.00	34.50	39.00	43.50	48.00	52.50	57.00
17	19.25	21.50	26.00	30.50	35.00	39.50	44.00	48.50	53.00	57.50
17 1/2	19.75	22.00	26.50	31.00	35.50	40.00	44.50	49.00	53.50	58.00
18	20.25	22.50	27.00	31.50	36.00	40.50	45.00	49.50	54.00	58.50
18 1/2	20.75	23.00	27.50	32.00	36.50	41.00	45.50	50.00	54.50	59.00
19	21.25	23.50	28.00	32.50	37.00	41.50	46.00	50.50	55.00	59.50
19 1/2	21.75	24.00	28.50	33.00	37.50	42.00	46.50	51.00	55.50	60.00
20	22.25	24.50	29.00	33.50	38.00	42.50	47.00	51.50	56.00	60.50
20 1/2	22.75	25.00	29.50	34.00	38.50	43.00	47.50	52.00	56.50	61.00
21	23.25	25.50	30.00	34.50	39.00	43.50	48.00	52.50	57.00	61.50

When a lender is able to get a high service fee, it can get its entire investment in the loan back very quickly, particularly when the loan is sold at a premium. This was illustrated by the example on page 50 where the lender would recoup its 10-percent investment in less than 2 years.

IMPROVEMENTS TO THE SECONDARY MARKET ARE NEEDED

The potential of the secondary market to assist small businesses would be enhanced by controlling servicing fees and encouraging lenders to consider making fixed rate loans when appropriate. Accounting inconsistencies should be corrected to overcome investor problems and to improve the marketability of SBA-guaranteed loans. Likewise, recordkeeping problems should be resolved so that SBA's oversight is better ensured and so that lender servicing fees can be monitored.

Controlling lenders' service fees needs a closer look

The Capital Access Committee noted that some lenders were receiving high service fees that usually do not result in any lower interest rate benefit to the small business borrower. Consequently, the committee recommended that a ceiling be imposed on the servicing fees received by lenders who originate loans and rapidly resell them. Specifically, the committee proposed that lenders who sell loans within 6 months of approval be limited to a service fee of 3 percent. The committee also suggested that no restriction be placed on the servicing fee for loans held longer than 6 months. The committee's rationale for this distinction was that loans held more than 6 months expose lenders to market fluctuations and, therefore, to market risks. For example, there is a market risk to lenders making fixed rate loans during periods of rising interest rates since the value of the loans as assets would depreciate. Accordingly, the committee believed lenders are entitled to whatever rewards they obtain for accepting these market risks.

We agree that servicing fees need to be controlled if small businesses are to benefit from lower interest rates through the secondary market. However, we are not sure that imposing a predetermined ceiling, especially as high as 3 percent, represents any significant improvement over the current situation. We believe that controlling servicing fees based on the loan's size, the extent of loan servicing performed by the lender, and the relationship of premiums to service fees are more equitable measures on which to set fee structures. Further, we agree with the Capital Access Committee that the length of time a loan is held should be considered in controlling service fees. However, the time the loan is held primarily relates to fixed rate loans, since variable rate loans have little market risk over time.

Only 11 percent of the loans sold through the FTA had service fees of 3 percent or more as shown in the table on page 52. This percentage includes some loans that were held by lenders for more than 6 months. Accordingly, the committee's recommendation that service fees be limited to 3 percent on loans held by lenders for less than 6 months would affect less than 11 percent of all loans sold based on statistics for the last 3 years.

Further, a service fee of 3 percent allows lenders to make yields of over 40 percent on loans sold at face value, as shown in the service fee table on page 53. In contrast, limiting service fees to 2 percent would still allow lenders to realize yields of more than 30 percent and would have affected about 38 percent of the loans sold.

The committee report did not consider the size of the loan as a factor in limiting service fees. The larger the loan, the greater the amount the lender earns as a fee. However, there is no direct dollar for dollar correlation between the size of the loan and the amount of servicing performed by a lender. Consequently, for a small loan the 3-percent servicing limitation may be appropriate while conversely it may permit excessive profit on a larger loan. For example, if a lender makes a $50,000, 90-percent guaranteed loan at 15 percent and sells the $45,000 guaranteed portion to a secondary market investor who takes a 12-percent rate, the 3-percent difference results in a service fee of about $1,350 ($45,000 x .03) during the first year of the loan. However, if the loan is 10 times as large, the lender will receive a service fee 10 times as great, or $13,500 ($450,000 x .03).[1]

The committee did not consider the extent of lender servicing in setting service fee limitations. There seems to be no relationship between the amount of servicing actually done by a lender and the fee charged. Rather, the size of the servicing fee is based on the price the investor is willing to pay the lender when the loan is sold.

Finally, the committee report did not address the relationship between service fees and premiums. Lenders can circumvent the committee's recommendation to limit service fees to 3 percent by charging investors a premium and not passing any interest rate savings along to the small business borrower, as illustrated by the following hypothetical example. In actual practice, substituting a premium for a lower servicing fee is more complex, necessitating consideration of amortization tables and the present value of money.

> Example: Assume that the prime rate is at 13-1/4 percent and the lender charges the maximum allowable rate over prime (2-3/4 percent), the small business' borrowing cost would be 16 percent. Further, assume that a secondary market investor is willing to buy the guaranteed portion of the loan--$100,000--for a 12-percent yield. The

[1]Annual service fee compensation will decrease in subsequent years as the loan balance decreases.

4-percent differential gives the lender a 4-percent servicing fee, or $4,000. Theoretically, if the committee's recommendation were implemented, limiting the servicing fee to 3 percent, the lender would be precluded from charging more than 15 percent on the loan and a 1-percent interest savings would accrue to the borrower.

However, assume the lender charges the investor a $1,000 premium in addition to the $100,000 purchase price of the guarantee. By being charged a premium the investor will require a higher yield as compensation for that premium. Assuming the yield required is 13 percent, the lender can continue to charge the small business borrower 16 percent and also make $4,000 during the first year. The lender would still be in compliance with the committee's recommended 3-percent limitation; however, the objective of that recommendation, lowering the small business' borrowing costs, would not have been achieved.

Factors such as the loan size, extent of servicing, and impact of premiums must be considered for servicing fees to be effectively controlled. These factors, along with the length of time the loan is held--primarily for fixed rate loans--need to be adequately addressed to assure that a servicing fee structure is equitable to both lenders and borrowers.

Using the secondary market to encourage fixed rate lending has potential

The secondary market has been used by some lenders as a tool to offer borrowers the stability of fixed rate loans. However, we believe the process offers greater potential for making fixed rate loans available.

Several States have initiated actions to encourage more fixed rate SBA loan guarantees in conjunction with the secondary market process. One such initiative is the Minnesota Plan, a pilot program intended to respond to small business needs for long-term, fixed rate, capital asset financing in the State of Minnesota. The plan was conceived and proposed to SBA by the Minnesota Small Business Finance Agency (MSBFA) and was authorized for implementation by SBA in August 1982 as a 1-year pilot program.

Briefly, the plan offers an approach for using the secondary market that requires close cooperation between MSBFA and the Minnesota banking community. It requires MSBFA to initially sell taxable, long-term fixed rate bonds to investors in $5 million to $10 million lots. Proceeds from the bonds are placed with a trustee for investment in the guaranteed portion of SBA

fixed asset loans made by banks. This arrangement provides banks with an additional marketing tool for their customers and a liquid secondary market. In return, banks work with MSBFA to tailor the loan terms to correspond to the interest rate and maturity of the bonds. As small businesses pay the participating banks, the banks in turn pay MSBFA, which then retires the bonds in accordance with a predetermined schedule.

In a notification of its intention to go forward with the pilot program SBA stated that it would:

> "* * * conduct a critique and evaluation in order to determine whether, and to what extent this pilot program has accomplished its stated purpose effectively and efficiently and whether a permanent program of this type would be in the best interest of the small business community."

We believe that certain technical details of the pilot program should be included in an evaluation, such as

- --how the timing of bond sales with loan commitments affected small business interest rates and how those rates would be affected during periods of interest rate instability and

- --how successful the plan was in matching guarantee loan maturities with the maturities of the bonds.

Another initiative to encourage more fixed rate lending involves the concept of loan pooling. Loan pooling refers to the grouping together of loans with homogeneous characteristics (for example, maturity periods and interest rates) for sale to investors. The Capital Access Committee recommended in its report to the SBA Administrator that a loan pooling program be established to make it more feasible for large financial institutions to purchase large quantities of SBA-guaranteed, fixed rate loans in the secondary market. The committee felt that by enlarging the secondary market demand for these loans, the rate of return required could be reduced and fixed rate financing could be made more available.

The committee reported that many larger financial institutions have been reluctant to invest in SBA-guaranteed loans because of the wide variety of loans offered in the secondary market and the absence of sizable blocks of loans with similar characteristics and an easily determined final maturity and average life. The committee believes that if blocks of SBA-guaranteed, fixed rate loans were offered in pools of $10 million to $25 million, they would attract significant numbers

of institutional buyers. In theory, the large transaction sizes would permit lower yields, generating savings that could be passed on to the small business borrowers who would also benefit from the emphasis on fixed rate loans.

Investor interest in purchasing fixed rate SBA loans has increased as interest rates have fallen. The declining interest rates offer an excellent opportunity to get more lenders to offer fixed rate loans. There are indications that increased fixed rate loan activity has been hampered because SBA regulations require that the interest rate be set at the time of loan application rather than at the time the loan is disbursed. The impact of this problem was brought out in an October 1982 report by the House Committee on Government Operations. The report cites comments made by an SBA lender:

> "The procedures * * * for making a fixed rate loan are fairly cumbersome. You make a commitment to the borrower and the rate is established. Then it may take 6 months for all the paperwork to be done in order to sell off the guarantee [in the secondary market].
>
> "No lender of our size would take the risk of making a fixed rate loan at the beginning of the loan process hoping you could sell it off to maintain your profit, 6 months later. As a result, we can only do variable rate loans * * *."

Pricing fixed rate loans at the time of loan disbursement would also make them more of a lending option during rising or fluctuating interest rate periods since the interest rate would be more certain.

Mounting investor concerns could affect SBA loan marketability

Secondary market investors are attracted to SBA loans because the loans are fully guaranteed by the Government and have attractive yields. Discussions with nine of the largest purchasers of SBA loans, accounting for 31 percent of the loans sold through the FTA, revealed problems which, if not corrected, could seriously affect the marketability of these loans. These investors identified problems including

- --reconciling payment differences between their records and those of the FTA,
- --losing premiums due to prepayment of loans, and
- --failing to receive timely payment from SBA on defaulted loans.

Major investor problem

By far the most significant investor problem is reconciling payment differences caused by a lack of a uniform method of computing interest. This causes a great deal of confusion for both investors and the FTA. Further confusion arises when lenders change their method of accruing interest on existing loans.

There are two generally accepted methods for accruing interest on SBA loans. These are:

--Actual/365: Interest is calculated on the exact number of days in the year and charged for the actual number of days in the month from the previous month's payment.

--30/360: Interest is calculated on the basis of a 360-day year and each month is counted as 30 days.

The problem of accounting for interest was particularly nettlesome to one investor who told us that he became so disgruntled that he sold virtually his entire $8 million portfolio of SBA-guaranteed loans. Two other investors, including one who purchased $45 million in guaranteed loans, stated that because of problems in reconciling payments they were no longer purchasing the loans.

Investors tended to blame the FTA for these problems. At our request, one investor provided specific examples of payment discrepancies with the FTA. We discussed these examples with the FTA which disclosed that the problems were largely attributable to the lack of a standardized method of calculating interest. Other factors such as untimely and/or partial payments by lenders and mail processing delays also contributed to the payment discrepancies. For example, the FTA estimated that each month about 20 percent of lender remittances are late, causing delays in paying investors. According to the FTA this is usually caused by borrowers not making timely payments to lenders. While a senior vice president in charge of the FTA program said he appreciated investor concerns, he pointed out that the FTA can only pay out what it receives.

The Small Business Committee on Capital Access, cognizant of investors' concerns, addressed the interest rate problem. The committee made the following recommendations:

--Require lenders to stipulate their methods of accruing interest.

--Require the FTA to remit interest due on a standard accrual calculation.

--Require lenders to remit principal and interest on a timely basis.

The committee recommended that lenders be required to declare the method of accruing interest when the loan is sold and stay with that method throughout the life of the loan.

The committee also recommended that the FTA remit interest to the investor as calculated on a 30/360 basis regardless of the method used by the lender. The committee believed that this would enable the purchaser of SBA loans to calculate the anticipated interest more easily and to forecast cash flow more accurately, making an investment in SBA loans more attractive.

Lastly, the committee recommended that the method of lender remittances be revised. Presently, a lender must remit to the FTA any payments received during the month. If payments are not received, then nothing is forwarded to the FTA. Under the committee's proposed revision, the lender would be required to remit principal and interest payments to the FTA by the last business day of the month following the month in which the borrower's payment is due, whether or not the payment was actually received by the lender. In essence the lender would be permitted to retain the equivalent of 1 month's payment to ensure a steady stream of payments to the investor. According to the committee, by ensuring investors of timely payments, the attractiveness of SBA-guaranteed loans could be considerably enhanced.

We believe that the recommendations proposed by the Small Business Committee on Capital Access, if properly implemented, will mitigate many of the paperwork and recordkeeping concerns cited by investors. The first recommendation can be implemented administratively. The second recommendation requires that any differences between payments made by the FTA and those remitted by the lender be settled at the end of each FTA contract period. SBA would reimburse the FTA for any shortfalls and receive any aggregate overpayments. SBA should determine whether it has the authority to implement this recommendation.

The committee's third recommendation, as presented, could probably be implemented administratively through a provision in the secondary market sales agreement. However, in our judgment, a more effective alternative of ensuring timely payment would be to use the FTA. The FTA offers the advantage of a single source

to ensure timely payment to investors. Conversely, the committee's recommendation requires numerous lenders to remit timely payments to the FTA with no provision to assure continuous payments to investors should some lenders not comply. Using the FTA as the centralized source has the benefit of eliminating the chance of noncompliance because of lenders not remitting payments. However, an impediment to the use of the FTA in this manner is that an initial pool of capital would have to be provided to the FTA to assure the steady stream of payments to investors. SBA would have to determine whether it has the authority should it decide to use the FTA in this manner.

The nine large investors we contacted commented that the committee's recommendations, if implemented, would make SBA loans more attractive. Most of the investors also said they would accept a lower interest rate; some 1/4 to 3/4 percent lower. Therefore, these recommendations, if combined with better controlling of servicing fees discussed on page 54, could lead to reductions in small business borrowing costs.

Other investor problems

Other investor concerns mentioned less frequently included loss of premiums on prepaid or defaulted loans and SBA delays in settling closed-out loans. When an investor purchases a loan at a premium, it pays the lender or broker more than the loan's face amount to acquire the loan. For example, if an investor buys the 90-percent guaranteed portion of a $500,000 SBA loan at a 2-percent premium (102), it will pay $500,000 x 90 percent = $450,000 x 1.02, or $459,000--a $9,000 premium. SBA's guarantee covers principal and interest on the loan but does not extend to the premium. Consequently, if the borrower either prepays his loan or defaults a short time after repayment begins, the investor risks losing the premium and could lose money on the investment.

Investors also complained about delays in receiving payment from SBA on defaulted loans. For example, one large investor told us that SBA normally takes 2 to 3 months to pay off on defaulted loans. The investor's loan service supervisor said that two SBA repurchases exceeded even their worst expectations. For one loan, payment was demanded from SBA in September 1981 but was not received until June 1982. Payment on the second loan was demanded in February 1982 and had not been received as of the end of July 1982.

We were unable to assess the magnitude of these problems because SBA does not keep readily usable records of loans sold.

Secondary market sales are not accurately reported

SBA district and branch offices, which are required to report secondary market sales, understated fiscal year 1981 activity by about 19 percent. Currently, SBA makes little use of the secondary market sales data. The reports that are submitted by the field offices are summarized but are not regularly analyzed or otherwise used by SBA to manage the program.

These inaccuracies do not matter much if the reports are not used; however, we believe that greater use could and should be made of data about secondary market activity. For example, if the secondary market is going to be used to promote more use of fixed rate loans as we suggest on page 56, accurate statistics are needed to analyze how many fixed and variable rate loans are being made by lenders and what the rates on these loans are. Also, the reports could be used to monitor and control service fees charged by lenders. For these reasons, and to improve administrative oversight of the secondary market process, we believe that more attention to recordkeeping is needed.

SBA procedures require field offices to maintain a monthly log of all loans sold in the secondary market to assure their easy identification and control. A copy of this log is to be sent monthly to SBA's Office of Secondary Market Activities in New York where summary schedules are prepared showing the number of loans sold and the dollar amounts of these loans for each of SBA's 10 regional offices. Once SBA's New York office has prepared the summary schedules, the reports are forwarded to the FTA. The monthly reports are used by the FTA to get a perspective on its share of the secondary market. When the FTA finishes with the reports, they are returned to SBA's New York office which forwards them to SBA's Investment Division in Washington where they are maintained on file. The data is not used further by management.

We reviewed all logs submitted by SBA field offices in fiscal year 1981 to determine their completeness and accuracy. Our review disclosed numerous omissions and errors which undermine the utility of the summary reports. Specific problems noted are highlighted below.

First, we encountered a problem in distinguishing between loans sold using the FTA and transactions directly between lenders and investors. SBA's procedures do not require field offices to distinguish on their monthly logs between these two methods of selling loans. Only 9 of the 68 reporting field offices routinely made a distinction. We were able to determine the accuracy of field office reports for those loans sold

through the FTA by comparing the reports with the FTA's computerized records. According to the FTA's records, 1,630 loans were sold through it in fiscal year 1981. However, SBA field office reports accounted for only 1,324 of these sales, leaving 306 loans, or 19 percent, not accounted for.

To test the accuracy of the FTA's records we reviewed the source documents on 185 of the 306 loans that were not reported by the field offices. This validation showed that 179 of the 185 tested loans were actually sold in fiscal year 1981 and simply not reported by the SBA field offices. The remaining six were either FTA keypunch errors or loans sold directly between lender and investor prior to fiscal year 1981 and converted in fiscal year 1981 to use the FTA services.

The reporting accuracy of secondary market sales varied widely among district and branch offices. Some offices always submitted completely accurate reports or reports with only an occasional omission. However, others had many omissions and five did not submit any reports during fiscal year 1981. These five nonreporting offices had 109 loans sold according to the FTA's records.

The extent of loan omissions has had an important effect on the accuracy of reported secondary market sales activity. For example, 3,022 loans were sold in fiscal year 1981 totaling $480.6 million according to the SBA New York office's records. These amounts include loans sold through the FTA as well as those sold directly between lender and investor. The 19-percent understatement represents only the loans sold through the FTA for which we were able to get comparable figures. Since field office reports include both methods of transactions, it is logical to assume that loans sold directly between lenders and investors were also understated by about 19 percent on the field office reports.

The Director of the Office of Secondary Market Activities, while aware that reporting problems existed, expressed concern about the high percentage of omissions. We discussed with the director two options for dealing with this problem. Both would require developing a centralized, automated file on all loans sold in the secondary market so that complete analyses could be performed and adequate oversight of the process maintained.

Under the first option, the current field office log would no longer be used and a more informative data file would be established. SBA's Director of Office of Program Policy Evaluation designed an input form for establishing a much improved data base. (See app. V.) We discussed this revised form with staff in four SBA district offices, and all stated that it would not require any more work to complete than the current log.

To obtain a centralized computer file under this option, SBA field offices could either enter the data on secondary market transactions directly to SBA headquarters or batch the transactions for central keypunching in SBA headquarters. Also, a data element could be set up in the SBA loan file to indicate that the loan had been sold in the secondary market. This would facilitate comparisons of such characteristics as interest rates between loans sold and not sold, which now only can be done through a very inefficient process.

The second option would be for the FTA to provide a central settlement service. Under this option all documents and sales agreements as executed by seller, purchaser, and SBA would be forwarded to the FTA. Upon receipt of funds from the purchaser, the FTA would create a permanent loan record, wire funds to the seller, and forward the loan package to the purchaser. The loan record established by the FTA, on all loans sold, would be maintained on a computerized file for analysis by SBA.

Centralized control is the primary advantage of using the FTA service since responsibility for maintaining an accurate file is placed on one entity. The primary drawbacks to using the FTA are cost considerations and lender preferences to deal directly with investors. The FTA estimated a one-time charge of $80 per transaction for centralized recording, $20 of which would go to SBA for administrative purposes. Since about 50 to 60 percent of transactions presently are not sold through the FTA, sampling of lender/investor reaction to such a change would probably be prudent in evaluating the merits of this option.

As previously discussed, the alternative to using the FTA is to improve present field office reporting. This option has the primary advantage of allowing lenders the choice of using or not using the FTA's services. On the other hand, this option has the major disadvantage of relying on more than 70 field offices to correctly report data on sales transactions. Obviously, this increases the margin for error over using a single entity--the FTA.

CONCLUSIONS

The secondary market for SBA guaranteed loans has benefited small businesses because it helps lenders to make longer and larger loans than they could otherwise and it provides lenders with funds to make additional small business loans. Some lenders are able to offer their small business borrowers the stability of fixed rate financing often by preselling the guaranteed portion of the loan.

The extent of secondary market activity is governed by conditions in the credit markets as well as by lenders' policies. Many lenders did not need the additional financing obtained by selling loans in the secondary market because recent demand for small business loans has diminished due to the poor economy and high interest rates. However, other lenders, particularly nonbank lenders, adopt policies to sell all or most of their guaranteed loans in order to leverage their funds and increase loan yields.

Aside from increasing the availability of funds, SBA also expected that the secondary market would result in lowering small businesses' borrowing costs. However, our comparison of interest rates on loans sold in the secondary market with those not sold showed no significant difference in interest rates. According to the Capital Access Committee, these fees need to be controlled if small businesses are to receive lower interest rates.

Investors are encountering problems with their SBA loans that have hurt the reputation of these loans in the secondary market. Some investors have decided not to purchase any more SBA loans because of confusion about methods for calculating interest and their failure to receive timely remittance of principal and interest. Recommendations made by SBA's Capital Access Committee should, if properly implemented, help correct these problems.

The secondary market process offers the potential to make fixed rate loans available to small business borrowers. Several innovative approaches, such as the Minnesota Plan and loan pooling, may also provide alternatives for getting more fixed rate loans out to the small business sector. Currently, SBA regulations require that the interest rate be set at the time of loan application rather than at the time the loan is disbursed. More lenders would be encouraged to offer fixed rate lending if the interest rate could be agreed upon when the loan was actually disbursed.

Administrative problems also plague the secondary market process and cloud its visibility. The process operates without formalized goals and objectives and clear lines of responsibility within SBA have not been defined. Reports and records on loans sold in the secondary market are inaccurate and incomplete and generally not used by management for administrative oversight. These administrative problems have to be addressed to effectively deal with other problems such as controlling servicing fees, resolving mounting investor concerns, and making fixed rate loans more available to small businesses.

RECOMMENDATIONS

To improve the secondary market's effectiveness in making more funds available to small businesses at a lower cost, we recommend that the SBA Administrator:

--Direct the Associate Administrator for Finance and Investment and the Director, Office of Secondary Market Operations, to develop procedures to clearly state SBA's goals and objectives in promoting the secondary market. Also, clarify functional responsibilities for overseeing the implementation of these objectives.

--Develop better procedures for keeping records of secondary market transactions, including service fees and prices paid by investors for loans. The Administrator should determine whether improved recordkeeping controls could be accomplished more efficiently by internal changes in SBA's procedures or by using the services of the FTA for all loans sold in the secondary market.

--Direct the Associate Administrator for Finance and Investment and the Director, Office of Secondary Market Operations, to develop a strategy for using the secondary market to offer small businesses the option of fixed rate financing. This strategy should address the desirability of actions such as the Minnesota Plan, the use of loan pooling, and the advantages and disadvantages of setting interest rates on fixed rate loans at the time of loan disbursement.

--Implement the recommendation of the Capital Access Committee that would require lenders that sell SBA-guaranteed loans to stipulate their methods of accruing interest and then continue to remit funds on this basis as long as the loan is active.

--Determine whether SBA has the authority to implement the recommendation of the Capital Access Committee which would require the fiscal transfer agent to remit interest to the investor as calculated on a 30/360 basis, regardless of the actual interest accrual method used by the lender. If SBA has this authority, we further recommend that the Capital Access Committee's recommendation be implemented.

--Request from the fiscal transfer agent a formal proposal on how it could function as a central

paying agent. Determine whether this proposal or the recommendation of the Capital Access Committee that would require lenders to remit principal and interest on a timely basis is the more preferable and act accordingly.

We further recommend that if the Administrator decides to control servicing fees, as recommended by the Capital Access Committee, he take certain steps to ensure that the Committee's intent of lowering borrower interest rates is achieved. Specifically, we recommend that the Administrator not establish a fixed fee but rather design regulations or procedures that limit the servicing fee as a function of loan size, premium to be paid, length of time the loan is held, and any extraordinary lender services to be provided. A period of testing should be carried out to determine the feasibility of controling servicing fees in this manner.

AGENCY COMMENTS AND OUR EVALUATION

SBA agreed with all but one of our recommendations and stated that the recommendations should prove very helpful in addressing some operating problems in the loan program. While in basic agreement with a proposal in our draft report to establish controls on the amount of lender servicing fees, SBA did not see a practical means for implementing it. However, SBA agreed that, after a period of testing, a means for implementing this recommendation may be identified.

We modified our earlier proposal in response to SBA's comments. We now recommend that SBA test the feasibility of controlling servicing fees based on specific loan characteristics, should the Administrator decide to control servicing fees.

CHAPTER 4

CHANGE IS NEEDED IN SBA's INTEREST RATE

POLICY ON GUARANTEED LOANS

High and unstable interest rates have contributed to the bankruptcy of businesses and have caused others to deplete their capital reserves. For small businesses receiving SBA-guaranteed loans this situation has heightened legislative and administrative concerns over whether

--SBA's current interest rate policy is contributing to higher rates and

--alternatives to the current policy might result in more favorable rates.

The Chairman, Senate Small Business Committee, asked us to review options for regulating SBA-guaranteed loan interest rates and their likely impacts on the program.

We studied alternatives SBA can use in establishing the maximum allowable interest rate and also the option to eliminate the national interest rate ceiling and rely on loan officers to determine the reasonableness of interest rates. Unfortunately, available data does not provide a clear basis for determining whether regulation or elimination of the national ceiling is preferable. While each alternative has benefits and drawbacks, we were able to identify specific actions that the Administrator should take under either alternative to better ensure that the interest rates on SBA loans are more closely aligned with prevailing market rates. The choice between regulation and elimination of the national ceiling is SBA's; however, its current interest rate policy should be changed.

CONGRESSIONAL CONCERNS OVER SBA's CURRENT REGULATORY POLICY

The Small Business Act of 1953, as amended, requires the Administrator to assure that interest rates charged on guaranteed loans are reasonable. The act does not define "reasonable." However, pursuant to this requirement, SBA has since 1962 established a maximum allowable interest rate that can be charged on SBA-guaranteed loans. SBA's current maximum allowable interest rate consists of a base interest rate, or benchmark, plus an allowable margin above the benchmark. The current benchmark is the lowest prime rate of any money center bank as announced in the "Wall Street Journal." The regulations provide two margins based on the length of the loan; 2-1/4 percent for loans under 7 years and 2-3/4 percent for loans over 7 years.

The former Administrator provided some insight into the criteria SBA uses in establishing its regulatory policy in his July 1981 testimony before the Subcommittee on General Oversight, House Committee on Small Business. He said that SBA's policy in "setting an interest rate ceiling is to keep participant interest rates as low as possible and still provide the necessary incentive to encourage lenders to lend to new small business ventures and other small businesses." He also stated that the benchmark used to calculate ceilings must satisfy two prerequisites: (1) be widely available and readily recognizable to the general public from some source other than the lender and (2) be available every business day.

As interest rates fluctuated widely during 1979-81 (see p. 78), congressional committees increasingly questioned the effectiveness of SBA's regulatory policy to ensure the reasonableness of guaranteed loan interest rates. Congressional concerns focused on whether the prime rate is an appropriate benchmark or whether it has led to higher rates for SBA borrowers. The committees were critical of the fact that there is no universally accepted definition of the prime and that the margin allowed over the prime is excessive since many loans are made at rates below prime.

For instance, a House Committee on Banking, Finance, and Urban Affairs staff report issued in April 1981 stated that data in a July 1980 Federal Reserve report shows "that the large banks in New York City made more than 60 percent of the business loans below the publicly announced prime in four of the last five quarters." The report also presented the results of a staff survey which, among other things, asked the 10 largest banks in the country to define their "prime rate." None of the banks gave the same definition for the prime rate and the definitions given were not clear. Some stated that they did not have prime rates. Others indicated that the prime rate is a qualitative as opposed to a quantitative decision.

For example, one bank stated that its prime rate was the rate charged on 90-day loans to "substantial customers." This bank also stated that it makes a wide variety of loans that can be priced below prime. Another bank defined its prime rate as the rate it publicly announced from time to time as its prime rate. This bank also stated that it had a lending program through which short-maturity loans are available at rates frequently below the prime rate.

The substantial amount of below prime lending, together with the uncertainty over its exact definition, led the committee staff to question the prime's appropriateness as a benchmark for interest ceilings. Specifically, the staff concluded that:

> "Federal agencies operating credit programs--such as the Small Business Administration--should not peg their interest rates to the announced prime

> rate. These agencies should use their own resources to determine the real benchmark rates existing in the economy."

Another committee that expressed concern about using the prime is the Subcommittee on General Oversight, House Committee on Small Business. In July 1981 this committee held hearings on the appropriateness of the prime rate as a benchmark for SBA's interest rate ceiling. During the hearings, the subcommittee chairman expressed his concern over using the prime rate as a benchmark and stated he believed that there was "widespread agreement that a new peg rate should be selected that represents a market measure--not a priced-fixed measure--of change in lending costs."

An October 1982 House Committee on Government Operations report concluded that the prime rate is an artificial rate and that SBA should stop using the prime as a benchmark. The committee recommended that SBA consider rates for fixed rate loans based on Treasury securities with comparable maturities and for variable rate loans based on the 3- or 6-month Treasury securities rate.

While the concerns raised are understandable, they require further explanation. Loans are made below prime for several reasons, including (1) the loan size and maturity, (2) the banking relationship with the borrower, and (3) the rates on alternative sources of capital.

The effect of loan size and maturity was discussed in the July 1980 Federal Reserve report which stated that:

> "Below prime lending at large money center banks mainly represents very large extensions of credit for very short periods at rates linked to money market rates."

This was also brought out in the report's transmittal letter wherein the Chairman of the Federal Reserve Board stated that high instances of subprime lending by large banks "can be explained by very large loans of very short maturities." Similarly, SBA's largest lender, Bank of America, in an August 28, 1982, letter stated:

> "When loans are made to customers below a bank's prime, they are usually made with specific funding of matching maturities, for very large amounts, and on relatively short terms."

The relationship between banks and their business customers also accounts for loans made at rates below prime. For example, a business may keep significant amounts of funds in the bank as

a compensating balance for the loan. These compensating balances can increase bank yields and lead to subprime lending. However, banks are prohibited from increasing their yields on SBA loans by requiring compensating balances.

Finally, large companies can issue commercial paper to obtain needed funds rather than borrow from a commercial bank. The banks compete with the yields paid on commercial paper in order to keep large businesses as customers. As commercial paper yields decline, banks are more likely to lend at rates less than prime to their larger customers. This was explained in a August 27, 1981, letter to SBA from the First National Bank of Boston. The bank stated:

> "As interest rates climbed to their recent high levels, the country's most credit worthy businesses spurned their existing short term commercial bank lending arrangements. Instead, alternatively, they turned to the Commercial Paper Market which offered lower rates. As a result, commercial banks such as ourselves offered short term loans at a rate more closely reflecting the alternative funding source available to these customers. Such rates include substantially lower spreads than was previously normal. However, the banks are desirous of balancing the risk in their portfolios by including the companies, judged to be of the highest credit quality, which could obtain commercial paper financing. Furthermore, these loan arrangements are for limited duration, usually not in excess of 60 days, and are offered on an uncommitted as and when available basis."

The Chairman of the Subcommittee on General Oversight, House Committee on Small Business, expressed his opinion that the benchmark should be a market measure rather than a priced-fixed measure of changes in lending costs. This means that the benchmark is determined through market competition--for example, auctions on Treasury bills--as opposed to lender-established rates as in the case of prime. The implications of these two pricing mechanisms on small business borrowing costs are discussed further on pages 72 to 79.

A dissenting opinion concerning the specific recommendation of the October 1982 House Committee on Government Operations report provides an explanation of the prime. It states that:

> "The prime rate represents a rough benchmark for the cost of money against which interest rates are based for widely diverse groups of borrowers. In this context, we recognize that borrowing costs, both above and below prime, reflect all the diversity of business, place, and time which we

traditionally associate with commerical lending activity in a large and complex economy."

While the dissenting opinion agreed with the "need to develop an improved pricing mechanism for SBA loans," it expressed the need for lender consensus on an adequate replacement for the prime rate. Factors critical to evaluating regulatory options to the prime rate, our analysis of those options, and a discussion of eliminating the interest rate ceiling are contained in the following sections.

CHANGES NEEDED IF SBA CONTINUES TO SET AN INTEREST RATE CEILING

The goal of SBA's interest rate regulation is to establish a reasonable rate that will achieve a desirable level of loan activity. Concern over SBA's use of the prime has centered attention on finding a more precisely defined benchmark as a means to arriving at a better understood and potentially lower rate.

It is unlikely that any change in the benchmark would result in a significant aggregate reduction in interest rates. This is because the margin would have to be adjusted so that the allowable rate would encourage lender participation. However, other alternative benchmarks would better ensure that rates on SBA loans are reasonable by aligning them more closely with prevailing market rates. These alternative benchmarks are also better defined and consequently, if used, would defer most of the uncertainty inherent in the regulatory process to the margin determination.

Factors critical to evaluating regulatory options

We discussed the following three criteria with SBA officials, bankers, broker/dealers, and investment bankers. All agreed that these were the primary factors that should be applied in evaluating the efficacy of alternatives for a regulatory benchmark for SBA-guaranteed loans.

First, the benchmark should be comparable in maturity to the interest rate adjustment periods on SBA loans. This is necessary to better ensure that interest rates on SBA loans are consistent with market-determined rates. The market traditionally demands a higher yield for fixed rate, longer maturity loans because lenders face a greater uncertainty of future changes in the value of capital. Variable rate lending transfers this interest rate risk to borrowers by allowing lenders to periodically adjust interest rates over the life of the loan.

Second, the benchmark should be widely available, readily recognizable, and available every business day to the general

public from some source other than the lender. Together with other criteria, this should promote borrower and lender acceptance of the benchmark and provide the clarity necessary for effective program administration.

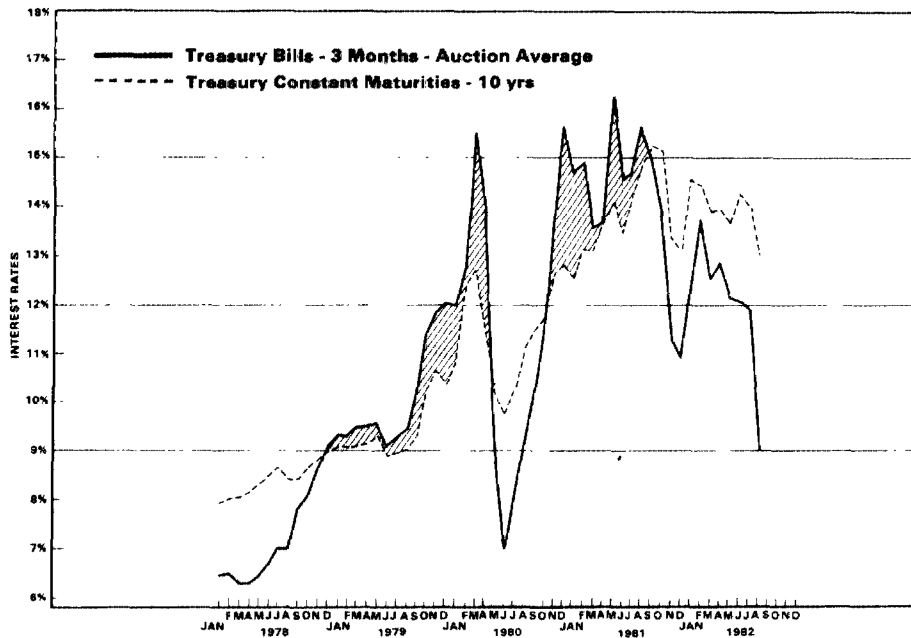
Third, the benchmark should be indicative of changes in banks' cost of capital which is a primary determinant of the interest rates banks charge their customers. Ideally, a benchmark would reflect the actual cost of capital to a bank in today's market. This becomes increasingly important as banks' obtain more of their capital at current market rates. On average, at all banks the percentage of these market rate deposits to assets has increased from 36 percent in 1978 to 48 percent in 1980. At banks with assets less than $100 million the percentage of those deposits to assets has increased from 13 to 36 percent during the same period. These smaller banks are SBA's primary lenders. Selecting a benchmark that closely reflects the cost of funds to banks would provide a rational basis from which to establish a margin.

We used the above three criteria to evaluate SBA's current regulatory policy and assess alternative regulatory benchmarks. In doing so we found that the prime rate is not an appropriate benchmark for fixed rate loans but should be considered as an alternative benchmark for variable rate lending.

SBA should change the benchmark for fixed rate loans

SBA's use of the prime rate to regulate interest rates on long-term fixed rate loans is inappropriate. This policy has allowed lenders, under certain market conditions, to price these loans higher than prevailing long-term market rates. This occurs because no single benchmark, including the prime rate, can be effective in pricing both fixed and variable rate loans.

SBA loans are usually long-maturity loans that can be made at either fixed or variable rates, resulting in different lender risks. Variable rate loans permit the lender to make quarterly adjustments to interest rates thereby reducing the interest rate risk to that of a short-term loan. On the other hand, fixed rate SBA loans have the usual interest rate risk associated with long-term lending. The following graph depicts the interest rate on long-term and short-term securities showing how their relationship has varied.



During much of the above period--from December 1978 through August 1981--short-term interest rates were uncharacteristically higher than long-term rates as shown by the shaded area in the graph. Interest rates charged by commercial banks also followed the trend.

The following table, which is based on data collected in the Federal Reserve's "Survey of Terms of Bank Lending," shows that short-term interest rates on commercial and industrial loans were generally higher than long-term interest rates from the end of 1978 through most of 1981.

Dates of survey	Average interest rate on short-term loans	Average interest rates on long-term loans
Nov. 1978	11.44	11.38
Feb. 1979	12.27	12.01
May 1979	12.34	12.08
Aug. 1979	12.31	12.25
Nov. 1979	15.81	15.56
Feb. 1980	15.68	15.45
May 1980	17.75	18.37
Aug. 1980	11.56	12.06
Nov. 1980	15.71	15.07
Feb. 1981	19.91	19.26
May 1981	19.99	19.25
Aug. 1981	21.11	20.26
Nov. 1981	17.23	18.94

SBA's policy of using the short-term prime rate as a benchmark for fixed rate loans did not account for the shift in the relationship between short-term and long-term rates. As a result interest rates on some fixed rate loans were priced higher than the market dictated. This is illustrated by high lender servicing fees during the period.

As discussed on page 50, the service fee is the difference between the interest rate charged by the lender and the yield demanded by the investor. While interest rates on SBA loans rose in response to increases in the short-term prime, investors' long-term yield demands increased more slowly in response to conditions in the market. Consequently, some lenders received unusually high service fees. For example, according to the FTA's records, 26 loans were sold during June and July 1980 with an average service fee of 4.67. The table on page 53 shows that this service fee translates into a yield of about 60 percent.

The above pricing problem was pointed out to SBA by the Association of Government Guaranteed Lenders in its August 6, 1981, response to SBA's July 1981 proposal to eliminate the margin over prime. The association stated:

> "Prime rate has nothing to do with long term fixed rate loans. Prime today is 20.5%. Fixed-rate loans today are approximately 17%."

The above discussion depicted the problems in using the prime as a benchmark for regulating long-term fixed rate loans during periods when interest rates were uncharacteristically high. Another problem, different but equally serious, can occur when interest rates on long- and short-term loans assume their traditional relationship. Specifically, lenders could be discouraged from making fixed rate loans if the prime is used as a benchmark unless an adequate margin above prime is provided. Discussions with officials in the financial community indicate that an adequate margin is more critical given market conditions today than it was several years ago for reasons described below.

Before 1979 interest rates were in their historical pattern with long-term rates being higher than short-term rates. At that time interest rates banks paid for deposits and charged for loans were held to relatively low levels by legislation and regulation. Willingness of lenders to make long-term loans at fixed rates was conditioned by their realization that the cost of money would not--because of regulatory interest rate ceilings--vary significantly over the period of the loan. Also, SBA's margin over prime afforded a sufficient yield.

During 1982 interest rates again assumed their traditional relationship. While lenders made fixed rate loans, they made them only because SBA's margin over prime was still adequate for them to make an acceptable yield. This point was brought out in a letter to SBA from Merrill Lynch recommending that SBA not implement its July 1981 proposal to reduce the allowable interest rate to prime. Similar concerns were raised by many lenders. For example, one bank commented that SBA's proposal to limit the rate to prime would be a disincentive to offer fixed rate loans, "when yield curves are in their historical pattern."

Progressive decontrol of the banking industry has made interest rates much more sensitive to short-term economic conditions, a fact that further supports the need to establish a benchmark reflecting market conditions. Treasury notes and bonds would be a big improvement over the short-term prime rate as a benchmark for SBA's fixed rate loans. Treasury notes have varying maturities up to 10 years and bonds have maturities over 10 years.

Interest rates paid on Treasury notes and bonds are widely available through financial publications and readily recognizable to the general public from a source other than the lender. However, the public's ease of access to all the rates on a daily basis is limited since the Treasury does not issue most notes and bonds at predetermined intervals. At time of issuance, however, rates paid on those obligations are published in financial newspapers including the "Wall Street Journal." While ease of access is a problem, using Treasury note and bond interest rates would provide much better assurance of consistency with the market. This advantage, in our judgment, far overshadows the one disadvantage.

Pros and cons of alternative benchmarks for variable rate loans

The prime rate and the rates paid on short-term instruments, such as Certificates of Deposit and Treasury bills, have maturities comparable to interest rate quarterly adjustment periods on SBA variable rate loans. They are issued with maturities of 3 months. Therefore, each reflects the interest rate risk on those loans.

All are widely available and readily recognizable to the general public from some source other than the bank and are available on a daily basis. The following is an excerpt from the "Wall Street Journal's" January 24, 1983, edition.

MONEY RATES
Friday, January 21, 1983

"The key U.S. and foreign annual interest rates below are a guide to general levels but don't always represent actual transactions.

"PRIME RATE: 11%. The base rate on corporate loans of large U.S. money center commercial banks.

"CERTIFICATES OF DEPOSIT: 8.05% one month; 8.10% two months; 8.15% three months; 8.40% six months; 8.62% one year. Typical rates paid by major banks on new issues of negotiable C.D.s, usually on amounts of $1 million and more. The minimum unit is $100,000.

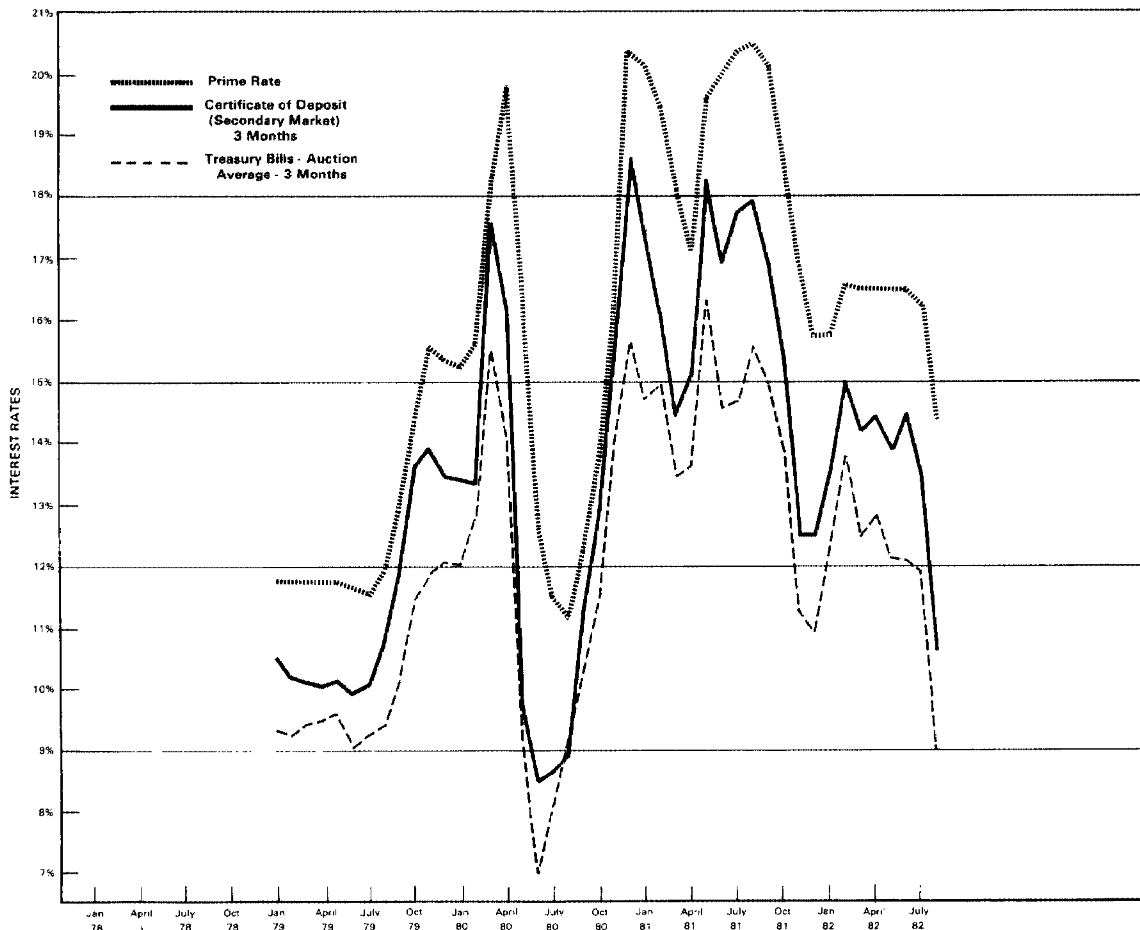
"TREASURY BILLS: Results of the Monday, January 17, 1983 auction of short-term U.S. government bills, sold at a discount from face value in units of $10,000 to $1 million: 7.62% 13 weeks; 7.73% 26 weeks."

All alternatives are generally indicative of changes in banks' cost of capital. Certificates of deposit are an important source of banks' borrowed funds. For example, large negotiable certificates of deposit represented about 14 percent of all banks' total assets in 1981.

The interest rate paid on Treasury bills is also indicative of changes in banks' cost of capital and is recognized by the financial community as a leading indicator of the general level of interest rates in the economy. Because banks compete with the Government for funds in the economy, changes in interest rates on Treasury bills presage changes in banks' cost of funds.

Finally, while the prime rate is generally indicative of banks' cost of funds, it tends to lag behind decreases in short-term market rates. Although the causes for this lag are not definitely known, it does result in slightly higher costs than if certificates of deposit or Treasury bills were used as the benchmark.

The following graph shows the rates on the alternatives for the period January 1979 to July 1982.



Money market certificates are a primary source of small banks' deposits, accounting for about one-third of their interest-bearing liabilities. However, we did not consider them a sound alternative because the actual rates paid, as reported by individual banks, are not published routinely on a national basis and the other alternatives are equally satisfactory in reflecting short-term market rates.

All short-term alternatives discussed appear to satisfy our criteria to varying degrees. SBA should select one alternative as a benchmark to facilitate administration of the regulation.

Treasury bills and Certificates of Deposits most closely meet our criteria and would be acceptable benchmarks for

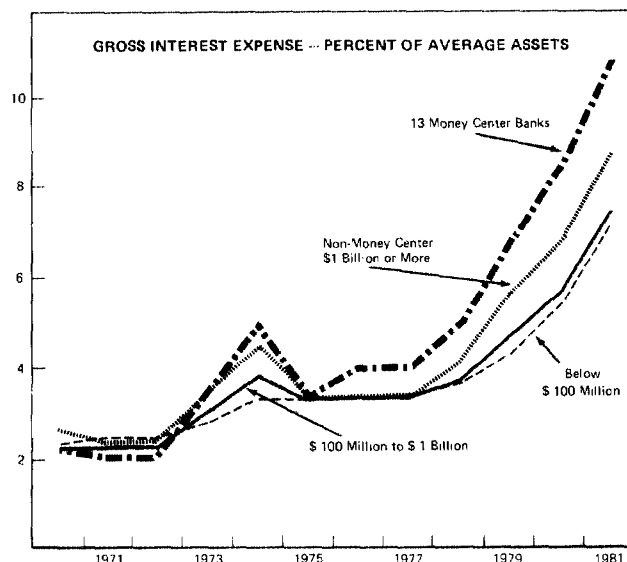
variable rate loans. The prime rate falls somewhat short of meeting our criteria because it is somewhat less reflective of changes in banks' cost of capital; however, it is the most widely used pricing mechanism in the banking industry. Because SBA relies on banks to participate in the program, SBA in deciding whether to change the benchmark should consult with the banking industry to determine (1) how an alternative benchmark would affect their lending practices and (2) what changes would be required in the level of the margin over the benchmark.

ESTABLISHMENT OF A MARGIN OVER THE BENCHMARK

The next step in the regulatory process is establishing a margin over the benchmark. In accordance with the Small Business Act of 1953, as amended, in setting a margin SBA should strive to establish a reasonable maximum allowable rate. In addition, the Administrator must weigh the effect of any given rate on the level of loan activity. Factors to be considered in setting the margin include variances in banks' costs of capital, operating costs, and borrower risk.

According to an SBA official, the current margin was designed to encourage lenders to participate while providing a reasonable rate of interest to small business. Efforts to fine tune the margin to accomplish these objectives are hampered by variances among lenders' capital and operating costs and borrower risk.

Money center banks and large banks located in other large urban areas generally have higher costs than their smaller counterparts. The following graph shows variances that exist among banks of different sizes in their cost of capital.



SBA can accommodate these variances and obtain widespread participation by establishing the margin at a sufficiently high level to account for the differences in lender costs and borrower risk. Hypothetically, a rate that is the highest any lender would require would encourage maximum bank participation. On the other hand, progressively lower rates would limit lender participation.

According to the banks participating in the guaranteed loan program, SBA cannot significantly lower interest rates through regulation without causing a corresponding decrease in program participation. For example, SBA announced in July 1981 that it planned to eliminate the margin over prime. Most lenders responded by stating that such a reduction would reduce the profitability of SBA loans and would lead to a significant decrease in their lending through the program. For instance, Bank of America stated:

> "The difference between banks' short term cost of funds and the "prime" rate usually has not been sufficient to permit banks to earn a profit on SBA guaranteed loans after considering servicing expenses and loan losses. Therefore, in our judgment, the proposed elimination of a spread over "prime" would make SBA guaranteed loans unattractive to lenders."

Echoing the industry's position, the SBA Administrator in an interview published by "Venture Magazine" in October 1982 pointed out that SBA's ability to do anything about high interest is limited. He said that:

> "* * * there is a whole chain of costs in a loan that is granted to a small business. A series of things happen which add to the costs for the borrower. We think that by reducing those administrative costs, we can possibly reduce interest rates by up to one percent. It's possible that one area we'll work in is to eliminate the ceiling of 2-3/4% above prime which lenders can charge on SBA guaranteed loans."

SBA should consult with banking industry officials to determine the probable effects of different margins on loan activity and achieve a balance between the interest rate level and bank participation. We view this as a trial-and-error process. Also, because SBA guarantees up to 90 percent of loans in setting the margin, the Administrator must protect the Government against unreasonable risk. Although banks may be willing to lend and individuals may be willing to borrow, the risk factor to the Government should be considered in establishing the margin.

In any case, it should be understood that a margin is not a recommended interest rate, but is set to encourage banks with higher operating and capital costs to lend to SBA borrowers while making an acceptable profit. Conversely, banks with relatively lower costs would not be expected to charge the maximum rate. This general philosophy is expressed in SBA's standard operating procedures.

ELIMINATION OF NATIONAL INTEREST RATE CEILING--EFFECTS UNKNOWN

Opinion varies on whether SBA should eliminate the national interest rate ceiling. Since SBA has had such a ceiling since 1962, data is not available to assess the impact of removing this ceiling.

In May 1982 an SBA advisory committee recommended that SBA consider eliminating the interest rate ceiling. The committee believed that open competition among lenders would reduce interest rates. The committee also recommended that SBA establish a task force to consider other ways of lowering small businesses' borrowing costs.

In response to the recommendation, SBA's Administrator established the Small Business Committee on Capital Access composed of 15 members including representatives from commercial banks, investment banking firms, and investors in SBA-guaranteed loans. In its October 1982 report, the committee recommended that SBA eliminate the interest rate ceiling. The report stated:

> "The committee believes that the imposition of a maximum rate has been counterproductive because lenders have frequently treated it as a recommended rate, rather than a ceiling. Therefore, the committee suggests that no maximum rate be imposed. It is our belief that competition among lenders will insure that interest rates remain at reasonable levels."

The SBA Administrator is currently considering the committee's recommendation.

An argument against eliminating the national ceiling is that it could result in increased rates as profit-motivated lenders seek to obtain the maximum rates possible from the borrower. For example, one SBA district director we contacted was concerned that some banks could send loans with unreasonable rates to SBA for approval. Another district office official was concerned that in certain geographical areas the number of lenders is not adequate to assure competitive rates of interest. Conversely, other district officials agreed with the recommendation of the Small Business Committee on Capital

Access. These officials believed that competition would be adequate to assure market rates of interest.

If the Administrator decides to eliminate the national ceiling, SBA would still have to ensure the reasonableness of interest rates. SBA's current operating procedures require loan officers to consider prevailing local interest rates as a basis to ensure reasonableness. Should SBA eliminate the national ceiling, procedures should be established to guide loan officers as to what action to take when proposed interest rates on loan applications exceed prevailing local rates. SBA could require that these loan applications be reviewed and approved by the district director. In addition, under this option SBA should monitor interest rates as a basis to establish comparative data on rates.

CONCLUSIONS

Available data does not provide a basis to determine whether SBA should continue to use a national interest rate ceiling or rely on loan officers to determine the reasonableness of interest rates. If SBA chooses to continue regulating interest rates through a national ceiling, changes are needed in the way it computes the maximum allowable rate.

By continuing to use a national ceiling, SBA can automatically preclude rates that it considers excessive; however, the principal drawback is that small business interest rates could be increased to the extent that lenders view the ceiling as the recommended rate. By eliminating the ceiling, SBA would rely on competitive market forces to determine interest rates. The principal drawback of eliminating the national ceiling is that SBA has less central control over determining the reasonableness of interest rates.

If the Administrator decides that regulation using a national interest rate ceiling is more desirable, SBA should amend its current policy to recognize differences in interest rate risks associated with fixed and variable rate loans.

To ensure that its fixed rate loans are priced consistently with other long-term debt, SBA should discontinue using the prime rate as a benchmark for these loans. Treasury notes and bonds of comparable maturity are suitable benchmarks for fixed rate loans.

Variable rate loans, regardless of their stated maturities, have an interest rate risk similar to short-term loans because interest rates are adjusted on a quarterly basis. We found large Certificates of Deposit and Treasury bills to be suitable benchmarks for variable rate loans. Other alternatives did not meet our criteria as well. For example, the prime is less reflective of changes in banks' short-term borrowing costs.

However, the prime rate is also the most widely used pricing mechanism in the banking industry. Because SBA relies on the banking industry to deliver guaranteed loans, it should consult the industry before deciding whether to use an alternative to prime as a benchmark for variable rate loans.

Aside from needing two distinct benchmarks for fixed and variable rate loans, further analysis is needed to determine what margins or spreads from these benchmarks are appropriate to compensate lenders for the risks and costs associated with lending. A logical approach to establishing a meaningful margin is for the SBA Administrator to periodically consult with representatives of the banking industry. This process should provide a forum to consider the effects on loan activity of various margin levels.

Eliminating the national ceiling is also a viable alternative. However, under this option SBA should emphasize adherence to current operating procedures requiring loan officers to consider prevailing local rates as a basis to ensure reasonableness. Also, guidance should be provided about what to do when proposed rates on loan applications exceed local prevailing rates. Lastly, SBA should ensure that appropriate administrative controls are in place to monitor the reasonableness of interest rates.

RECOMMENDATIONS

We recommend that the Administrator, SBA, change the current regulatory policy by either

--continuing to regulate interest rates through a national ceiling but with different benchmarks for fixed and variable rate loans or

--eliminating the national maximum allowable interest rate and relying on procedures and guidance to field offices for determining the reasonableness of interest rates in their local areas.

If SBA continues to use a maximum allowable rate, we recommend the use of a long-term instrument, such as Treasury notes and bonds, of comparable maturity for fixed rate loans. We also recommend that Treasury bills or Certificates of Deposit be considered as alternatives to the prime as a benchmark for variable rate loans. We further recommend that the Administrator consult with representatives from the banking industry to determine how a change in the benchmark would affect their lending practices and their required margin. The Administrator should periodically consult with the banking industry to consider the effects of the margin on small business borrowing costs and lending activity as market rates fluctuate.

If the national interest rate ceiling is eliminated, we recommend that the Administrator emphasize to field offices the importance of adhering to existing standard operating procedures. These procedures require loan officers to consider prevailing interest rates in their geographic area in assessing reasonableness of proposed rates on loan applications. We also recommend that additional guidance be provided detailing what should be done when proposed rates on loan applications exceed local prevailing rates. We further recommend that the Administrator monitor interest rate trends on approved and declined loans to determine how the elimination of a national ceiling affects interest rates charged on SBA loans.

AGENCY COMMENTS

SBA agreed with our recommendations and said that it thought they would prove very helpful in its consideration of policy alternatives.

LOWELL WEICKER, JR., CONN., CHAIRMAN

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United States Senate

COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

July 28, 1982

Honorable Charles A. Bowsher
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

Recently, Committee staff met with representatives of your office to discuss an ongoing GAO study of the use of the secondary market for the Small Business Administration's (SBA) guaranteed loans. As a result of this meeting, the Committee staff expressed an interest in having this study expanded to include an assessment of some essential policy issues affecting the loan guarantee programs which are necessarily interrelated to the secondary market study.

These policy issues, relating to recent reductions in loan guarantee authority and proposed revisions to interest rate regulations, have long been of interest and concern to this Committee. Accordingly, I am requesting that your office's ongoing study be expanded to specifically address the following issues:

- Generally, why do banks use the SBA loan guarantee to finance small businesses?

- Would banks that provide financing to small businesses with an SBA loan guarantee provide these same loans at a reduced percentage rate, or at all, without an SBA guarantee.

- What are the advantages, and are there any disadvantages, to the use by banks of the SBA loan guarantee?

Honorable Charles A. Bowsher
July 28, 1982
Page Two

- To what extent, if any, do the SBA loan guarantee programs impact on the "credit market" or on the ability of small businesses not using these programs to obtain credit?

- How does the secondary market for selling SBA loans operate and what effect does the secondary market have generally on the activities of banks, small businesses and the SBA loan guarantee programs in terms of making additional financial assistance available to small businesses?

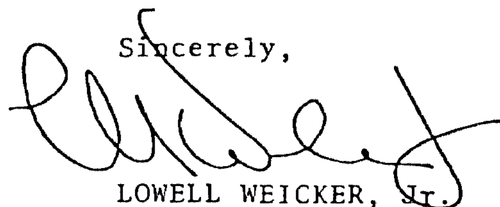
- What options are available for regulating interest rates on SBA guaranteed loans and what effect would each option, if implemented, have on the future of the SBA loan guarantee programs?

Your timely study and the answers to these questions at the earliest possible time, but certainly in time for our Committee's budget review process in early 1983, would be extremely helpful to the Committee in our ongoing review of the SBA budget, policies and management. This information would also help the Committee assess how these policy issues affect the decisions made by the banking and small business communities which place such great importance on the SBA loan guarantee programs.

If you have any questions regarding this request, please do not hesitate to have your staff contact the Committee's Chief Counsel, Mike Haynes, at 224-8487.

With every good wish, I am

Sincerely,



LOWELL WEICKER, Jr.
Chairman

QUESTIONNAIRE METHODOLOGY

Our questionnaire surveying bank participation in the SBA-guaranteed loan program and the secondary market was sent to a nationwide sample of 951 commercial banks that made at least one SBA guaranteed loan in fiscal years 1979, 1980, and 1981. To select a sample of banks that made loans within that time frame, we copied SBA's computer-maintained master loan records of all guaranteed 7(a) loans disbursed in fiscal years 1979-81. This gave us a universe of 8,907 banks, which had made approximately 71,000 loans during that time period.

We divided the universe of banks into three strata or groups--those with total assets under $100 million, those with assets between $100 million and $1 billion, and those over $1 billion. The reason for stratifying the banks was to minimize the sampling errors of the estimates. Questionnaires were sent to all banks whose total assets were over $1 billion and to independently selected random samples of banks in the other strata. Of the 951 questionnaires mailed, 739 usable responses (78 percent) were received. Another 35 responses to our questionnaire were received but were not in a usable form.

The universe and sample sizes for the three strata are shown below.

Stratum	Universe	Sample
Under $100 million	7413	337
$100 million to $1 billion	1320	440
Over $1 billion	174	174
	8907	951

The 951 questionnaires were mailed in June 1982 and a followup letter was sent in July 1982. We also sent a followup mailgram in August 1982.

Our evaluators, psychologists, and statisticians designed the questionnaire specifically for this review. Officials within SBA, the Office of Comptroller of the Currency, the Office of Management and Budget, the Independent Bankers Association, the American Bankers Association, and SBA's fiscal transfer agent,

the Bradford Trust Company, also reviewed and provided comments on the questionnaire. The questionnaire was pretested with bankers in several locations to aid understanding and minimize response time.

Since the estimates contained in this report were developed from a scientific (statistical) sample, each estimate has a measurable precision, or sampling error. For estimates near 50 percent, the sampling error is approximately 5.3 percentage points at the 95-percent confidence level.[1] Estimates greater than, or less than, 50 percent will have smaller sampling errors.

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[1]This means the chances are 19 out of 20 that if all banks were sent questionnaires, the results would differ by less than the sampling errors from the sample estimates.

U.S. GENERAL ACCOUNTING OFFICE SURVEY OF BANK PARTICIPATION IN THE SBA GUARANTEED LOAN PROGRAM AND THE SECONDARY MARKET

INTRODUCTION

The U.S. General Accounting Office, an agency of the Congress, is studying the process whereby lending institutions sell Federally guaranteed loans in the secondary market. As part of this effort, we are surveying a sample of lenders to obtain information regarding their participation in the SBA loan guarantee program and related secondary market activity.

Your answers will be treated confidentially. Neither your name nor the name of your organization will be disclosed in our report or outside of the GAO. Generally the information you provide will be reported in aggregate form. Although some individual responses may be disclosed in our report, such responses will not include any information which could be used to identify the respondent. The information provided on this questionnaire is exempt from public disclosure (GAO regulations 4 C.F.R. 81.5(a)(8)). This questionnaire is numbered only to enable GAO to follow-up with banks who do not respond to the questionnaire.

Please return the completed questionnaire within 5 days, if possible, to:

Mr. Frank J. Philippi
U.S. General Accounting Office
434 Walnut St. — 11th Floor
Philadelphia, PA 19106

We have provided a return envelope for your use.

If you have any questions, please call Ed Rotz or Frank Philippi at (215) 597-5050 or 597-4330.

BANK'S LENDING CHARACTERISTICS

1. Approximately what percentage of the total dollar amount (guaranteed and non-guaranteed) in your loan portfolio as of March 31, 1982 was in each of the following categories? *(Enter percentage for each; if none, enter 0.)*

NOTE: For the purpose of this questionnaire please consider Small Businesses to be non-farm, independently owned businesses with annual sales of under $5 million or less than $2.5 million in assets, and less than $1 million in loans at your bank.

1(5)

Category	Percent	
1. Small Business (non-farm) Loans	27 %	(6-8)
2. Other Business (non-farm) Loans	9 %	(9-11)
3. Farm Loans	15 %	(12-14)
4. Personal Loans	22 %	(15-17)
5. Home Mortgage Loans	22 %	(18-20)
6. Other(s)	5 %	(21-23)
TOTAL	100%	

2. What was the approximate dollar amount of loans your bank had outstanding to non-farm small businesses as of March 31, 1982? *(Enter amount.)*

Small Business Loans as of March 31, 1982 $14,116,000 (24-32)

— 1 —

3. Approximately what percentage of your small business (non-farm) loan amount outstanding as of March 31, 1982 *(reported in question 2)* carried an SBA guarantee? *(Consider the entire amount of the loan including the unguaranteed portion in arriving at this percentage.)*

Percentage of Bank's Small Business Loan Amt. Carrying SBA Guarantee 13 % (33-35)

4. Please enter below the average original loan amount for SBA guaranteed loans and other non-SBA small business loans in your bank's portfolio. *(Your best estimate will be sufficient.)*

Average Loan Amount-SBA $ 118,000 (36-41)

Average Loan Amount Other-non SBA $ 58,000 (42-48)

5. For each loan maturity period listed below, please enter the approximate percentage of the SBA and non SBA Small Business loans in your portfolio that originally carried the specified maturity period. *(Enter percent for each. If none, enter 0.)*

Maturity Period	SBA Loans		non-SBA Small Business Loans	
1. Under 1 year	2 %	(49-51)	52 %	(52-54)
2. 1-5 years	24 %	(55-57)	33 %	(58-60)
3. 6-10 years	59 %	(61-63)	11 %	(64-66)
4. Over 10 years	15 %	(67-69)	4 %	(70-72)
Total - All Loans	100%		100%	

Dup (1-4)
2 (5)

6. At present, what are the interest rates your bank charges for a typical SBA and typical non-SBA small business loan? *(Enter percentage points above or below prime (P) for each.)*

1. SBA Loans P + 1.48 % or P — ____ % (6-9)
2. Non SBA Loans P + 1.43 % or P — ____ % (10-13)

7. Compared to 3 years ago, have the number of applications for loans by small businesses at your bank increased, decreased, or remained about the same? *(Check one.)* (14)

1. [6] Increased greatly
2. [23] Increased somewhat
3. [34] Remained about same } **Skip to Question 10.**
4. [25] Decreased somewhat
5. [12] Decreased greatly } **Skip to Question 9.**

8. To what extent, if at all, has each of the following factors contributed to this increase in loan applications at your bank? *(Check one for each.)*

	Very great extent (1)	Great extent (2)	Moderate extent (3)	Some extent (4)	Little or no extent (5)	
1. Bank located in high growth area	9	24	18	15	34	(15)
2. Increased working capital borrowing by small business	5	33	36	21	5	(16)
3. More new business starts	2	17	31	38	12	(17)
4. Greater marketing emphasis on small business by our bank	11	26	21	17	25	(18)
5. Decreased competition from other lenders	–	6	7	13	74	(19)
6. Other(s) *(Specify.)*	49	29	4	17	1	(20)

Skip to Question 10 after answering Question 8.

9. To what extent, if at all, has each of the following factors contributed to this decrease in loan applications at your bank? *(Check one for each.)*

	Very great extent (1)	Great extent (2)	Moderate extent (3)	Some extent (4)	Little or no extent (5)	
1. High interest rates	50	45	3	1	1	(21)
2. Depressed local economy	23	37	20	14	6	(22)
3. Fewer new business starts	17	38	24	17	4	(23)
4. Increased competition from other lenders	1	2	14	22	61	(24)
5. Other(s) *(Specify.)*	9	17	-	11	63	(25)

SBA LOAN GUARANTEE PROGRAM

10. To what extent, if at all, has each of the following factors contributed to your bank's decision to offer SBA guaranteed loans during the past three years? *(Check one for each.)*

	Very great extent (1)	Great extent (2)	Moderate extent (3)	Some extent (4)	Little or no extent (5)	
1. Able to offer longer maturity loans	16	25	24	14	21	(26)
2. Able to offer more favorable interest rates	2	6	11	13	68	(27)
3. Able to offer loans to owners who have less equity in business than would be required for non SBA Loan	21	39	18	12	10	(28)
4. Able to offer loan to new business *(without established record)*	17	38	19	13	13	(29)
5. Able to make larger loan than bank's policy permits	13	18	12	12	45	(30)
6. Able to make larger loan than regulated lending limit permits	13	14	8	8	57	(31)
7. Able to hold SBA guaranteed paper as security for public funds or as collateral for Treasury and Loan Accounts	1	5	11	14	69	(32)
8. Able to make loan to line of business not generally served by our bank	3	6	12	17	62	(33)
9. Able to use SBA Loan *(with the secondary market sale option)* as hedge against future bank liquidity problem	9	10	13	14	54	(34)
10. Other(s) *(Specify.)*	14	5	24	6	51	(35)

— 3 —

11. If SBA's currently allowable interest rates on its guaranteed loans of 2 1/4 to 2 3/4 above prime were changed to the levels specified below, would your bank's participation in the SBA program increase, decrease, or remain about the same? *(Check one for each.)*

	Greatly increase (1)	Somewhat increase (2)	Remain about the same (3)	Somewhat decrease (4)	Greatly decrease (5)	
1. Remove interest rate restrictions entirely	4	14	79	2	1	(36)
2. Reduce maximum to some level between prime and current level	1	3	62	23	11	(37)
3. Allow interest rate to increase in increments of 1/2 of 1% for each 10% reduction in SBA's loan guarantee *(assuming current interest rate ceiling is lifted)*	1	6	73	13	8	(38)

12. Considering the credit needs of the small businesses in your area, do you feel the SBA guarantee limit of $500,000 should be increased? *(Check one.)*

1. [15] Definitely not (39)
2. [48] Probably not
3. [9] Uncertain
4. [16] Probably yes
5. [12] Definitely yes

Please specify the limit you believe should exist — $901,000 (40-46)

13. If the SBA guarantee rates were changed to the levels listed below, would the number of SBA loans made, SBA loan maturity periods, and SBA loan size increase, decrease or remain unchanged at your bank? *(Check three boxes for each.)*

	80% Guarantee					70% Guarantee					60% Guarantee					
	Greatly increase (1)	Somewhat increase (2)	Remain about the same (3)	Somewhat decrease (4)	Greatly decrease (5)	Greatly increase (1)	Somewhat increase (2)	Remain about the same (3)	Somewhat decrease (4)	Greatly decrease (5)	Greatly increase (1)	Somewhat increase (2)	Remain about the same (3)	Somewhat decrease (4)	Greatly decrease (5)	
1. Number SBA loans approved	2	4	58	29	7	–	1	23	48	28	–	–	18	18	64	(47-49)
2. Maturity period of SBA loans	1	7	66	18	8	–	2	39	35	24	1	1	31	19	48	(50-52)
3. SBA loan size	1	6	65	20	8	–	2	35	39	24	–	2	27	17	54	(53-55)

— 4 —

14. If the SBA loan guarantee program did not exist, about what percentage of your customers that currently have SBA loans would fall into each of the following categories? *(Enter percent for each. If none, enter 0.)*

1. Would not qualify for a loan	46 %	(56-58)
2. Would qualify but under different terms such as shorter maturity, higher interest etc.	36 %	(59-61)
3. Would qualify for loan with basically same terms	18 %	(62-64)
All SBA Customers	100%	

Dup (1-4)
3 (5)

15. Please enter below the approximate number of SBA guaranteed loans and the approximate total dollar amount of SBA loans your bank made with fixed and variable rates during your last 3 fiscal years.

1. Number SBA Guaranteed Loans - Fixed rate	5	(6-8)
2. Total amount SBA Guaranteed Loans - Fixed rate	$ 1,277,000	(9-17)
3. Number SBA Guaranteed Loans - Variable rate	4	(18-20)
4. Total amount SBA Guaranteed Loans - Variable rate	$ 1,049,000	(21-29)

USE OF SECONDARY MARKET

Note: In the mid-1970's a secondary market was created for SBA guaranteed loans, permitting banks to sell the guaranteed part of the loan to an investor. These sales may or may not be handled through a broker. The sale of the loan is consummated in a three-party agreement which is executed by the bank, SBA, and the purchaser. The agreement extends SBA's guarantee of the borrower's obligation from the bank to the purchaser. Sales can be made any time after the loan is properly closed and fully disbursed.

16. Approximately what percentage, if any, of the fixed and variable rate SBA guaranteed loans made by your bank during the past 3 fiscal years *(reported in question 15 above)* has your bank sold in the secondary market? *(Enter percentage for number of loans as well as total loan amount for fixed and variable rate loans.)*

1. Percent of Fixed Rate SBA Loans Sold	8 %	(30-32)
2. Percent of total dollar amount of Fixed Rate SBA Loans Sold	9 %	(33-35)
3. Percent of Variable Rate SBA Loans Sold	9 %	(36-38)
4. Percent of total dollar amount of Variable Rate SBA Loans Sold	10 %	(39-41)

If you answered 0% for all categories in Question 16, please skip to Question 24.

— 5 —

17. To what extent, if at all, has each of the following factors contributed to your bank's decision to sell SBA loans in the secondary market during the last three years? *(Check one for each.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	
	1	2	3	4	5	
1. Needed liquidity	24	25	16	19	16	(42)
2. Profit	22	37	18	11	12	(43)
3. Loan of lengthy maturity	12	32	13	21	22	(44)
4. Loan too large to retain	8	9	14	19	50	(45)
5. Other *(Specify.)*	19	19	2	-	60	(46)

18. For about what percentage of the SBA loans you sold during the past three years was your decision to sell the loan made prior to loan approval? *(Enter percent. If none, enter 0.)*

Percent loans sold where decision to sell made prior to loan approval 64 % (47-49)

If you answered 0% or 100% to Question 18, please skip to Question 20.

19. In those cases where you decide to sell an SBA guaranteed loan prior to loan approval, what effect, if any, does this typically have on the interest rate charged the borrower compared to those loans you don't sell at all or decide to sell after approval? *(Check one.)* (50)

1. [5] Would increase interest rate 1% or more
2. [14] Would increase interest rate less than 1%
3. [57] Would have no effect on interest rate
4. [11] Would lower interest rate less than 1%
5. [13] Would lower interest rate 1% or more

20. Approximately what percentage of your secondary market sales transactions during the past three years were handled by a broker? *(Check one.)* (51)

1. [19] None
2. [5] 1—25%
3. [1] 26—50%
4. [2] 51—75%
5. [7] 76—99%
6. [66] 100%

21. Approximately what percentage of the SBA guaranteed loans your bank sold in the secondary market during the past three years were sold at a premium above the face value of the loan, at face value (par), or at a discount from face value? (Please consider only the face value of the loan, and not the percentage, if any, you receive as an ongoing servicing fee on the loan.) *(Enter percentage for each. If none, enter 0.)*

1. Sold by bank at premium above face value of loan	25 %	(52-54)
2. Sold by bank at par	64 %	(55-57)
3. Sold by bank at discount	11 %	(58-60)
Total sold	100%	

22. For approximately what percentage of the SBA loans your bank sold during the past two years did you use FORM 1086 which requires the services of Bradford Trust Company as the Fiscal Transfer Agent (FTA)? *(Enter percentage; if none, enter 0.)*

Percentage sold using FORM 1086 ___31___ % (61-63)

23. How much of an incentive or disincentive is each of the following factors in deciding whether or not to use Bradford as the FTA? *(Check one for each.)*

	Major incentive (1)	Somewhat of an incentive (2)	Neither incentive nor disincentive (3)	Somewhat of a disincentive (4)	Major disincentive (5)	
1. Method of payment (one payment to multiple investors)	13	26	49	3	9	(64)
2. Investor preference for certificated loans	14	14	60	3	9	(65)
3. Level of protection offered our bank by 1086 settlement procedures	9	27	55	-	9	(66)
4. 1/8 of 1% fee for 1086 process	3	11	56	15	15	(67)
5. Amount of processing involved in 1086 procedure	3	13	59	13	12	(68)
6. 1086 process requires bank to pay late payment penalty	-	3	58	18	21	(69)
7. Other(s) *(Specify.)*	-	-	-	-	-	(70)

Dup (1-4)
4 (5)

24. How much of a reason, if at all, is each of the following in your decision not to sell SBA loans in the secondary market during the past 3 years? *(Check one for each.)*[a]

	Major Reason (1)	Somewhat of a reason (2)	Not a reason (3)	Not applicable all sold (4)	
1. Not that familiar with secondary market sale provisions	11	20	62	7	(6)
2. SBA loans represent small portion of our portfolio	46	25	23	6	(7)
3. Did not need liquidity	49	21	24	6	(8)
4. Insufficient yield or profit	13	17	62	8	(9)
5. Would lose deferment flexibility with the borrower because of third party interest	6	18	68	8	(10)
6. Loan guarantees are retained as "Collateral"	6	17	69	8	(11)
7. Other *(Specify.)*	54	2	30	14	(12)

OTHER ISSUES/COMMENTS

25. During the past 3 years, have there been any instances where use of the SBA guarantee enabled your bank to extend credit which you would have been unable to extend because your regulated lending capacity would have been exceeded? *(Check one.)* (13)

1. [36] Yes
2. [60] No
3. [4] Uncertain

[a] Column 4 was factored out to arrive at the percentages cited on p. 47.

26. It has been suggested that the SBA 7(a) program contributes to a distortion of private capital markets by causing increased interest rates and crowding out of other borrowers. To what extent, if at all, has the SBA 7(a) program affected your credit extension to other small business borrowers in your area in terms of the two factors listed below? *(Check one for each.)*

	Very great extent	Great extent	Moderate extent	Some extent	Little or no extent	
	1	2	3	4	5	
1. Increases interest rates for other small business borrowers	-	-	4	2	94	(14)
2. Crowds out other small business borrowers	1	-	2	2	95	(15)

27. If you have any additional comments regarding the SBA loan guarantee program, the secondary market, or related issues please enter them below. (15)

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

FEB 7 1983

J. Dexter Peach, Director
Resources Community and Economic
Development Division
U. S. General Accounting Office
441 G Street, N. W.
Washington, D. C. 20548

Dear Mr. Peach:

We have reviewed your draft report entitled, "SBA's 7(a) Loan Guarantee Program: An Assessment of Its Role in the Financial Market."

We are pleased to inform you that we are basically in agreement with the report with the following exception:

The second recommendation on page 57 states:

> "-- Establish controls on the amount of lender service fees. In deciding what these limits should be, the Administrator should consider the size of the loan, the yields lenders receive at various interest rate levels, and the amount of servicing actually performed by the lender."

We agree with the intent of the recommendation, but do not see at this time a practical means for implementation. It is possible that, after a period of testing, a means for employing these factors may be identified.

Aside from this recommendation, we have found the material presented in the report to be very informative and we believe it will prove to be very helpful in our consideration of policy alternatives and in addressing some operating problems in the loan program.

We appreciated the opportunity to comment on the report and if you need further information, please advise.

Sincerely,

James C. Sanders
Administrator

APPENDIX V

****

SECONDARY MARKET TRANSACTION REPORT

****

(1) SERVICING OFF. NO.:______(2)LOAN NO.:____________(3)TRANS.TYPE:_____1084
_____1085
_____1086

(4) DATE OF NOTE :___/___/___(5) ORIG.PRINC. AMT. :$______________
(Mo.) (Day) (Yr.)

(6) MATURITY DATE:___/___/___(7) ORIG.SBA GUAR.AMT. :$______________
(Mo.) (Day) (Yr.)

(8) PMTS.PER YR. :____________(9) OUTS.PRINC. AMOUNT :$______________

(10)PMT. AMT.
PER PERIOD :$____________ (11)OUTS.PRINC. AMOUNT
GUARANTEED INTEREST:$______________

(12)VARIABLE RATE:(Describe Base)______________________________

(13) DIFFERENTIAL(Spread from Base):__________%

(14) ORIGINAL NOTE VAR. INT.RATE :__________%

(15)FIXED RATE:ORIGINAL NOTE INTEREST RATE :__________%

(16)LENDER SERVICING FEE:(17)INITIAL PERIOD :________%(18)DURATION________

(19)SUBSEQUENT PERIOD:________%(20)DURATION________

(21)DOLLAR PRICE PAID BY BROKER/DEALER:(22)PRINCIPAL $______________

(23)ACC'D INT.$______________

(24)DOLLAR PRICE PAID BY PURCHASER :(25)PRINCIPAL $______________

(26)ACC'D INT.$______________

(27)BROKER/DEALER NAME:______________________________(28)ZIP__________

(29)BROKER/DEALER REP.:______________________________

(30)PURCHASER NAME :______________________________

(31)STREET ADDRESS :______________________________

(32)CITY OR TOWN :____________________(33)STATE________(34)ZIP________

(35)COMMENTS/FOOTNOTES:____

(Use reverse side of this form for additional comments if necessary)

(CAUTION:Do not approve or sign the 1084,1085,or 1086 until this report form has been completed pursuant to instructions.)

(36)SBA AGENT______________________________

(37)DATE OF TRANSACTION:___/___/___
(Mo.)(Day)(Yr.)

(077044)

*U.S. GOVERNMENT PRINTING OFFICE : 1983 0-381-843/46

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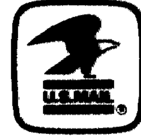

THIRD CLASS