STATEMENT

by

The National Association of Development Companies

on

The Small Business Administration

504 Loan Guaranty Program
Proposed FY 2003 SBA Budget

Submitted to the

COMMITTEE ON SMALL BUSINESS
&
ENTREPRENEURSHIP

UNITED STATES SENATE

by

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The National Association of Development Companies (NADCO) is pleased to provide a statement to the Senate Committee on Small Business & Entrepreneurship concerning the SBA budget proposed by the Administration for FY 2003. NADCO is the trade association for SBA 504 Certified Development Companies (CDCs). We represent 250 CDCs and more than 175 affiliate members, who together provided more than 98% of all SBA 504 financing to small businesses during 2000. NADCO's mission is to serve as the key advocate for the 504 program, and to provide program technical support and professional education to our membership. As the Committee knows, 504's objective is economic development and specifically job creation by funding the expansion of small businesses. No other Federal program can claim to have created almost 1,000,000 jobs[1] as the 504 program has done. This mission is more important today than ever before, with our economy stuck in neutral at best, and in recession at worst.

NADCO would like to thank Chairman Kerry, Senator Bond, and the entire Committee, for continued support of the 504 program and the CDC industry. Your Committee has worked closely with the Congressional leadership, SBA, and our industry to ensure the availability of capital to small businesses through the 504 program previous to and during this recession.

We have three objectives in providing this testimony to the Committee. First, NADCO would like to comment on the FY 2003 SBA budget. This includes the Administration's 504 authorization level, as well as the proposed borrower fees and subsidy model assumptions by SBA.

Second, we will comment on several of the management initiatives raised in the Administration's budget. Third, we will address the need for continuing vigilance by this Committee over the fees imposed by the Administration on our borrowers, first mortgage lenders, and CDCs for use of the 504 program.

PROPOSED SBA FY 2003 BUDGET

504 PROGRAM AUTHORIZATION LEVEL

SBA has proposed that the authorization level for the 504 program be set for FY 2003 at $4.5 billion. We support this level of authorization for 504. As the program continues to fund itself through borrower, CDC, and first mortgage lender fees, there is no cost to the Federal government, nor any Congressional appropriation.

The benefits to the country are numerous. New 504 projects provide new jobs in their communities by expanding the land, equipment, buildings, and employment levels for our borrowers. In turn, this expansion leads directly to new tax bases, including:

- **City & County real estate taxes from new construction projects**
- **State & local sales taxes from increased business revenues**
- **Federal & State income taxes from new and expanding businesses**
- **Federal & State payroll taxes from new employees.**

It is clear that businesses assisted by this no-cost program are contributing to the tax revenues received by all levels of local, State, and Federal governments. We encourage this Committee to support this authorization level during this economic recession when every job we create is putting someone back to work.

504 BORROWER FEE INCREASE

For the first time since the program went to zero subsidy in 1996, SBA and OMB is increasing the fee borrowers pay to subsidize the 504 program. This comes at a time when SBA's own re-estimates reveal that 504 is paying hundreds of millions of dollars into the Treasury in excessive fees. The fees are derived from the subsidy model, which is in turn based on several forecasts by SBA and OMB officials. Provided here is a brief review of the major model factors.

1. Loan Default Rate:

The factor with the greatest impact on the subsidy model is the default rate, or loan purchase rate forecasted by SBA. In 1996, SBA projected this rate to be about 19%, although there was virtually no history to support this guesstimate. Since that year, SBA has reduced their annual forecasts by over 50%. Unfortunately, even these large reductions have not led to accurate subsidy cost re-estimates for each loan cohort during the years following the loan funding.

For FY 2003, the 504 loan default rate improves from 8.4% down to 8.3%. Attached to this testimony is chart 1 provided by Bank of New York, the 504 program Trustee bank. This chart reveals two significant items. First, prepayments have recently spiked. More on this below. Second, loan defaults have actually remained fairly constant for the last ten to twelve years. Monthly defaults have generally been well below twenty to twenty-five loans per month for many years. During this time, our annual loan volume has grown from about $400 million to almost $2.5 billion.

Charts 2 and 3 provide a great deal of insight into 504 defaults. Chart 2 plots loan authorizations and defaults by year. It is clear that, with the exception of three years during and immediately following the 1989-1990 recession, the rate of increase of defaults was generally less than the overall increase in loan volume. Even for last year's recession, the rate of increase from 2000 to 2001 for defaults is less than the loan volume increase.

Chart 3 shows three factors that further clarify actual 504 defaults. Shown is the dollar volume of actual loan defaults by calendar year (see left side scale), from 1986 through 2001. Also shown (see right side scale) is the PERCENTAGE of annual defaults for each year of 504 loans. This is the portion of authorized loans that default each calendar year, and is somewhat different from SBA's data, which is based on fiscal year.

Finally, Chart 3 plots a polynomial equation curve fit for the history of percentage of 504 defaults. This is the mathematical equation that best fits the default percentage data on Chart 3. It is clear that the average percentage of defaults is at or below 4 – 4.5% since the recession years of 1989 – 1991. Even during and just after that recession, 504 defaults did not exceed 5%.

Further supporting our concern about the accuracy of SBA's default forecast is the President's own budget figures. On page 49 of the SBA Budget Request and Performance Plan is the following statement: ***"Defaults amount to about $60 – 70M annually".*** This statement agrees with our chart that 504 loan defaults have been very consistent for a number of years. At a rate of $2.5 billion in annual loans, this amounts to <u>less than a 5% default rate</u>. We ask the Committee to request reconciliation of this figure with the budget's forecasted factor of 8.3%.

2. 504 Loan Currency Rate:

SBA forecasts that 504's loan portfolio currency rate will decline from 98.5% to 95.5%. Given that last year saw the peak of this recession, we should expect the 2003 loans to improve, rather than decline in their currency rate. With virtually all 504 loans being for real estate, we cannot identify any reason why loans with such collateral would suffer any decline in their currency rate while SBA's forecasts for working capital loans maintain a constant level of currency. Our experience with business real estate loans is that these are the absolute last debt a business owner fails to pay. The owner knows that a default on his business property essentially drives his business to a complete failure when he is thrown out of his property by lenders. Most business owners pay their business property loans even before their home mortgages. We seek further clarification from SBA on this unusual forecast.

3. Loan Prepayment Rate:

SBA's forecast of the loan prepayment rate mysteriously increased following FY 2000 from 33% to 51% for FY 2002, and continues to be about 50% for FY 2003. This appears far too high, based on actual history of our portfolio. Obviously, when prevailing private rates are low (as now) there will be some prepayments of older 504 loans that have higher interest rates than available today. However, the loans that are now prepaying were funded in previous years, and thus not counted for this prepayment forecast. It is clear that 504 prepayments have spiked during the last year, as existing borrowers appear to be re-financing and leaving the 504 loans they took out years ago for lower interest rates in the private markets.

The FY 2003 subsidy model should forecast the EXPECTED rate of prepayments for this fiscal year of loans. The 504 debentures that fund our loans are being sold at historic low interest rates. Recent sales have been at rates below 6%. With no expected increase in long term rates for the near future, we do not believe that small business borrowers will find lower rates from the private markets, and decide to refinance their 504 loans in the next several years. Therefore, it is not likely the 2003 loan cohort will see a high level of prepayments. Thus, we disagree with SBA's assumption of a prepayment rate of 50% for FY 2003. We ask the Committee to obtain detailed information about this forecast, and compare it with recent historical trends of our actual portfolio prepayments as recorded by our Trustee bank.

4. Loan Recovery Rate:

SBA's forecast of their recoveries on defaulted loan collateral again declines – to an abysmal 20% from last year's 26.9%. We cannot understand this forecast, given the clear results of two on-going SBA programs that provide virtually all recoveries for 504 defaults. One program, the Congressionally-mandated 504 liquidation program, has had very positive results. With virtually all loans accounted for, the average recovery rate for both CDC and SBA staffed efforts has easily exceeded 50% of the outstanding 504 loan balance. This recovery level was achieved for both the CDC-liquidated loans and those liquidated by SBA's own staff.

The other program, the SBA asset sale program, has resulted in a sale of 872 loans for over $170 million. Again, the recovery rate has been over 50%. Even the Administration's own budget proposal notes that **"the Agency implemented a highly successful asset sale program and will continue to strategically sell our loan portfolio."** Frankly, if a 20% net recovery is the definition of highly successful, SBA should seriously consider allowing more private lenders and CDCs to perform the recovery process. 20% recovery just doesn't cut it.

The budget shows that the major reasons for continued decline in the net recovery rate are high collection expenses on the part of the agency. Each of the above initiatives – the CDC liquidation program and the asset sale program – should see very few direct SBA expenses. CDCs doing the 504 default recoveries are shouldering their collection costs. The asset sales should reduce liquidation and recovery costs for SBA, given that few staff are involved in sales and no servicing is needed for the loans being sold. Yet, it appears from budget assumptions that SBA's forecast of collection expenses remains extraordinarily high – almost 40% of the loan balances. It seems that either SBA's costs are out of control, or their new accounting system has not figured out which costs to allocate to the asset sales. Given the apparent successes of these two programs, we cannot understand how the overall recovery rate would continue its decline. We believe the Committee should seek detailed and independently verifiable information on the asset sales and the SBA loan recovery expenditures.

Additionally, during a recent budget review meeting with SBA, we learned that SBA collection forecasts do not include proceeds from secondary notes by loan guarantors, or notes from new buyers of foreclosed 504 assets. SBA did not provide any data on the number or total value of these notes that they now own. However, we believe that many 504 defaults result in either a sale of the real estate, with SBA taking back a note, or perhaps one of the original borrowers providing a new note to SBA based on his personal guaranty of the original 504 note. It would appear that the program subsidy model is counting as a total loss the payoff by SBA of the 504 debenture, but giving the program no credit for many recoveries that involve notes receivable. This is clearly lowering the overall recovery rate and increasing the future borrower fees for no reason. We ask the Committee to investigate this procedure, and correct it as quickly as possible. This should be done even for the FY 2003 budget model.

SBA MANAGEMENT INITIATIVES

Strategy #2: Manage Human Capital More Strategically

We support the need for this management strategy. With loan volume growth continuing even as SBA staff shrinks, SBA must "work smarter, not harder." There will simply not be enough field staff to perform all the loan underwriting, authorization, closing, servicing, and liquidation functions required of a $50 billion loan portfolio. The agency's existing PLP and PCLP programs point the way to the future; off-load work better done by others, and allowing SBA staff to perform quality lender oversight. You don't see the OCC performing individual loan underwriting and servicing actions, but everyone certainly thinks the banking industry is well regulated through OCC's audit and control functions. Perhaps SBA should emulate the OCC. Additionally, SBA's plan to expand centralization of many repetitive actions that require unique expertise is a very positive move. This has proven to be successful in the two loan servicing centers now in operation. These specialized staffs are able to increase productivity and reduce costs, while actually providing improved service to lenders and borrowers.

There is also increased focus on staff training. We endorse this objective, and hope it goes beyond only generic management or leadership training. With retirements by many senior field office staff, there appears to be declining expertise in the core lending and servicing skills needed to oversee SBA's programs. For a number of years, SBA staff participated in lending industry training, including NADCO's, to learn the same skills we teach our own industry members. We are encouraged that SBA may again focus on staff training, and suggest that the agency work with lender industry groups who provide cost-effective program training to their members. This method may be less costly than creating their own training programs on basic finance, credit, and lending.

Strategy #3: Improve Financial Management Information
Strategy #6: Improve Credit Program Management

We support the need for these objectives. The Loan Monitoring System actually began nearly five years ago as a joint review of the 504 program operations by SBA and CDC staffs. As I have observed this system development over the years, it has stopped and started several times – each time with different contractors who knew little or nothing about SBA lending programs, yet were expected to design systems to automate highly sophisticated lending and servicing procedures. This project appears to have made little or no progress, while burning through millions of taxpayer dollars. It should be "reconstituted" as stated by the Administrator, and should take advantage of the knowledge and skills of the lender industries that it will provide information both to and about. At this time, it does not appear that the agency has either the data processing or loan portfolio management skills to plan, design, or develop this system in-house.

We support the implementation of the Congressionally mandated liquidation authority for qualified CDCs. Long-standing Members of this Committee may recall that the liquidation pilot was actually our industry's idea to improve loan recoveries. Further, our member CDCs agreed to absorb the costs of liquidation and workout efforts due to agency budget shortfalls. The recently completed liquidation pilot dispelled the notion that numerous experienced CDCs might not be able to perform adequate loan recoveries. This pilot has been a sterling success through the joint efforts of talented SBA staff and many CDCs. Given SBA's forecast that their own recovery efforts may yield only a paltry 20%, it might be best for everyone if privatization of 504 loan recovery efforts was accelerated, rather than rely on the loan asset sales.

Increased Use of 504 For Larger Real Estate Loans

In order to stretch the appropriation for the 7(a) loan program, SBA indicates it may consider a forced shift of some real estate loans now done under 7(a) to the 504 program. We support efforts to increase awareness and use of the 504 program. We are also committed to ensuring that the program is being delivered throughout the U. S. through local CDCs. While SBA's proposal might appear to be a quick fix, there are a number of reasons why this may not work to the benefit of SBA's small business borrowers. Many projects financed under 7(a) simply won't qualify under current law or regulations for 504 loans. Among the reasons are:

- 504 cannot be used to refinance an existing permanent loan.
- 504 cannot normally be used for projects less than $100,000.
- 504 cannot be used if the borrower needs a term of less than ten years, or if a variable interest rate is best for the borrower.
- 504 cannot easily be used for a "mixed use" project, where the borrower also needs financing for working capital, inventory, receivables, or fixtures.
- Most importantly, 504 loans are for economic development, and have a strict job creation and retention requirement. Many 7(a) projects do not meet this standard.

Surmounting these restrictions would clearly require new legislation to modify Congressional intent for 504. Further, major regulatory and SOP revisions would be required of the agency. These would likely consume much of this and the next session of Congress, and much of the Administration's management time. It would also require substantial discussions with the lender industries to achieve any consensus on legislation or regulations. It does not appear that this proposal could be a short term fix for any 7(a) budget shortfall.

504 SUBSIDY: THE NEED FOR VIGILANCE

SBA's proposed FY 2003 budget increases the annual fee charged each 504 small business borrower from 0.410% to 0.425%. We are shocked and dismayed at this increase, in light of our understanding of the portfolio's performance and the success of key new liquidation initiatives.

While a relatively small increase in user cost, this change appears to herald a new and totally unjustified concern by the Administration about the performance of our 504 loan portfolio. We find this surprising. The most important subsidy model factor is loan defaults. In the SBA model, defaults actually are forecasted to decline.

As noted above, this is not a true "subsidy" model, but actually a cost model. There is no Congressional appropriation that provides a 504 subsidy. The fees paid by borrowers, our CDCs, and even our first mortgage lenders offset completely the program operating expenses and loan losses. Thus, this is a free program for the taxpayer.

Further, it is, in fact a cash cow, given that it is providing excess fees back to the Treasury. SBA's own re-estimates for this year demonstrate that 504 will have returned almost $400 million in excess borrower fees during the last five years.

We question how the agency can decide to increase the borrower fees when borrowers are actually providing hundreds of millions of dollars to the Federal government. The borrowers who use this program, and the CDCs and first mortgage lenders who pay additional fees to support the program, deserve to understand how the fees are calculated that they are being required by the agency to pay to the Federal Treasury.

In reviewing SBA's and OMB's program re-estimates last year, it was clear that 504 had gone the same way as the 7(a) program: we are now in "negative subsidy". That is, we were paying more into the Federal Treasury in borrower and user fees than the program actually is projected to cost. We believe this to be nothing less than an unauthorized tax on America's small businesses.

Data from SBA's budget reveals the following re-estimates by year:

- FY 1999: $13.032 million paid in excess fees to Treasury
- FY 2000: $9.676 million "
- FY 2001: $105.186 million "
- FY 2002: $180.143 million "
- FY 2003: $88.672 million "
- **Total 5 years: $396.709 million paid in excess fees to Treasury**

When SBA and OMB overestimate the true cost of our program, this is no longer a bureaucratic funny-money budget exercise. The result is real fees paid by real borrowers in real money to the U. S. Treasury. Six year ago, SBA "guesstimated" that the 504 default rate was 19%. There was absolutely no historical data to support this figure. With no appropriation, this led to our small business borrowers having to pay new and incredibly expensive program fees. Those borrowers from 1997 will be paying these fees in every loan payment every year for the entire twenty years of their 504 loans. While SBA can "re-estimate" its projections to correct future program forecasts, our existing borrowers will still pay the inflated fees from the old SBA program cost models. There is no correction provided to loans already in the portfolio.

The SBA-OMB 504 subsidy model results have been very inconsistent with our analysis of historical portfolio performance. Last year, OMB and SBA provided this Committee with projections of 504 defaults under a plan to reduce the reliance on very old and generally incomplete loan data. That is, SBA was considering shortening the "look back" period for our subsidy model. When finally given access to the results of their forecasts, we were quite surprised to find that they were very close to historical actual figures. We are puzzled about SBA and OMB's unwillingness to move to utilization of model interpretation that so clearly correlates with true history.

For example, the SBA-projected default rate for 504 dropped from about 11% to under 5% just by going to a shorter look-back period. This appeared to be very close to the 4+% that the program has achieved since its creation in 1986. We recognize that many of our loans are still "young" and future defaults can be expected. However, even SBA's own analysis has shown that the vast majority of defaults occur in the first four or five years of a loan pool. However, instead of correcting its model to better reflect the program's history, SBA is now considering a move to a totally new model: the Econometric Model, which has been discussed for several years.

Our industry is concerned that changing the model may provide no more accurate subsidy and borrower fee forecasts than the old model. In fact, we have never argued over the model structure, which is just a bunch of mathematical formulas set up in a giant financial spreadsheet. Our concerns center on how SBA and OMB look at our portfolio performance historical data, and come up with the forecasts they do. Thus, we believe they have a data interpretation issue, not a financial model structure issue.

We do not understand how changing the model is going to improve their track record of poor default, recovery, and prepayment forecasting, as demonstrated by the huge "negative subsidy" generated over the past five years. What this action will do is "re-set the game clock"; that is, they will now have five more years to demonstrate that they may eventually get a model that might provide accurate forecasts of our portfolio performance. Until they get it right, or until this Committee is finally fed up with these moving targets and misinformation, our 504 borrowers will continue to pay what we believe to be grossly inflated user fees. Assuming our program remains in "negative subsidy", these fees will continue to flow to the U. S. Treasury Department. As has been the case for the 7(a) program for years, these excessive fees will continue to amount to an unauthorized tax on our borrowers.

Our industry strongly objects to this situation. We ask the Committee get to the bottom of the Administration's gyrating program statistics, as Treasury- Postal Appropriations directed OMB in its Conference Report last year. We ask for a true determination of whether 504 is in "negative subsidy" and simply turning over excess fees to the Treasury. If this is the case, we ask this Committee and the Congress to initiate legislative steps to halt this practice. This may require that the Congress legislate our program's fees or place caps on these fees that are based on true program historical performance.

SUMMARY

Thank you for allowing NADCO to provide comments on the 504 subsidy model. CDCs are major stakeholders in the 504 program and want to do everything we can to ensure its long term viability. Even though we are at zero subsidy with no appropriation, we consider the program cost model factors to be a very serious matter. Our industry would like to work closely with the Committee to get to the bottom of the forecasting problems in our subsidy models, as revealed by the huge re-estimates calculated by SBA's own staff. We ask that the Committee request further analysis of our subsidy model by the General Accounting Office as soon as possible.

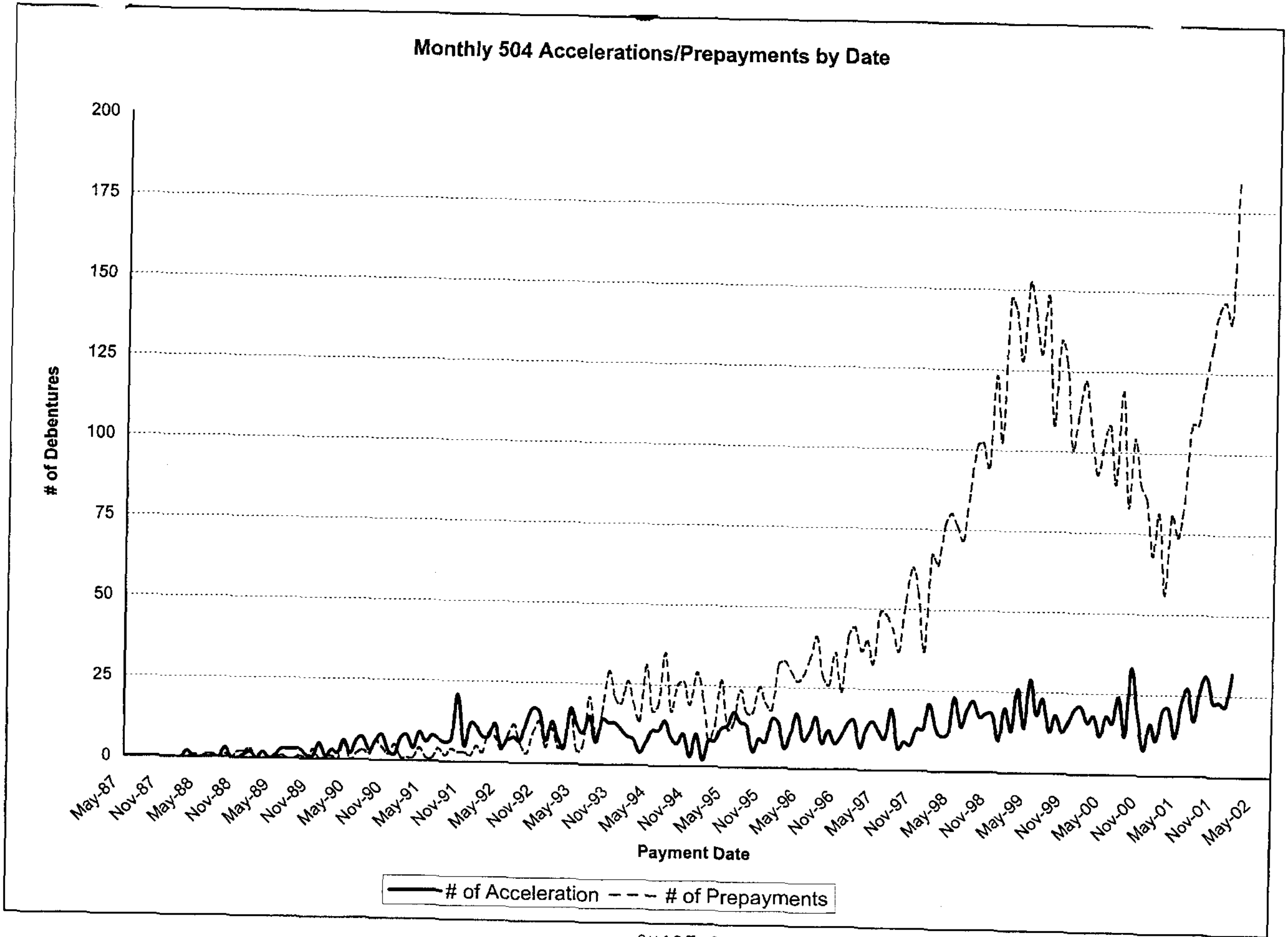
Monthly 504 Accelerations/Prepayments by Date
# of Debentures
200
175
150
125
100
75
50
25
0
May-87 Nov-87 May-88 Nov-88 May-89 Nov-89 May-90 Nov-90 May-91 Nov-91 May-92 Nov-92 May-93 Nov-93 May-94 Nov-94 May-95 Nov-95 May-96 Nov-96 May-97 Nov-97 May-98 Nov-98 May-99 Nov-99 May-00 Nov-00 May-01 Nov-01 May-02
Payment Date
# of Acceleration
# of Prepayments

CHART 1

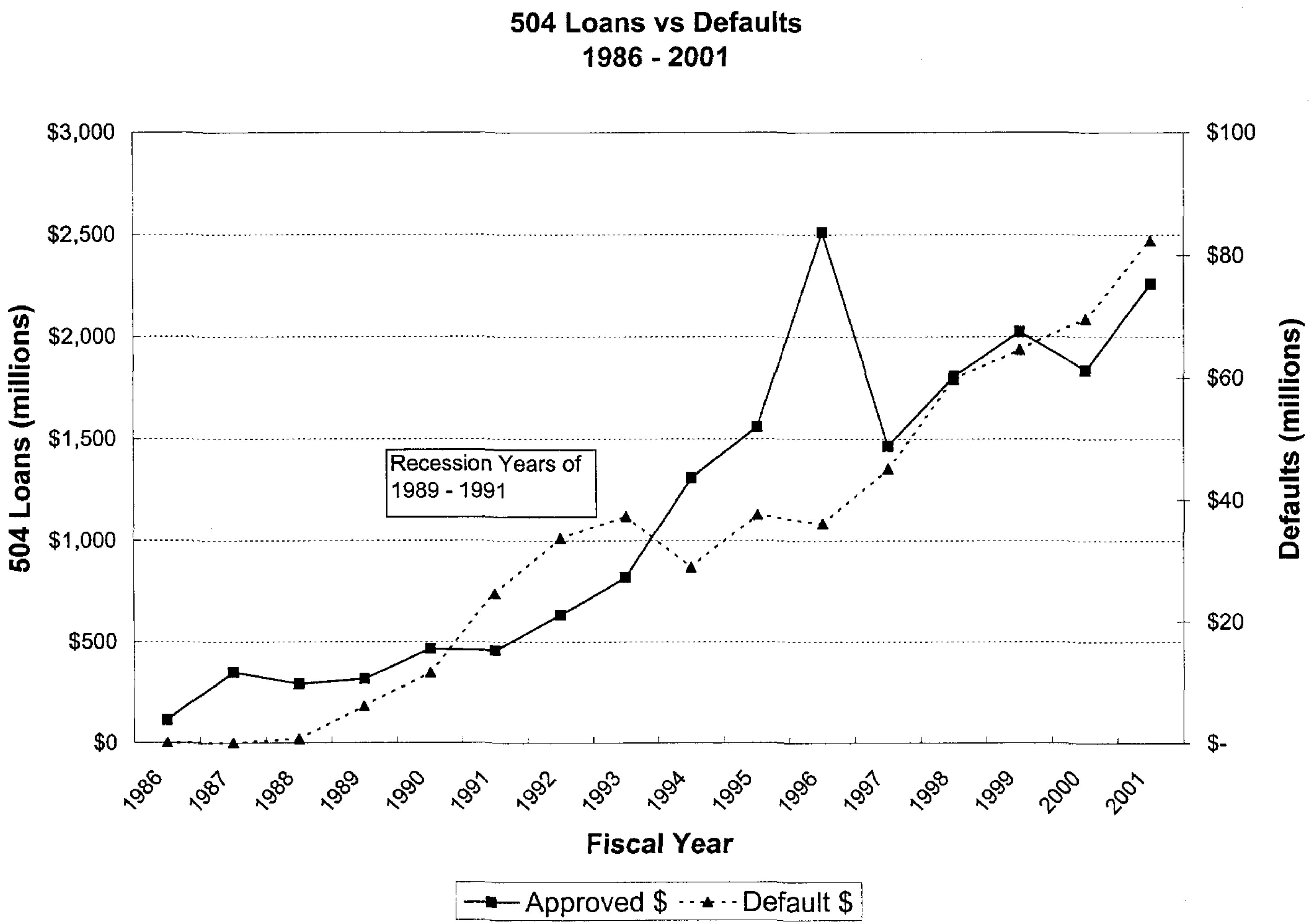
504 Loans vs Defaults
1986 - 2001
504 Loans (millions)
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
Defaults (millions)
$100
$80
$60
$40
$20
$-
Recession Years of
1989 - 1991
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
Fiscal Year
Approved $
Default $

CHART 2

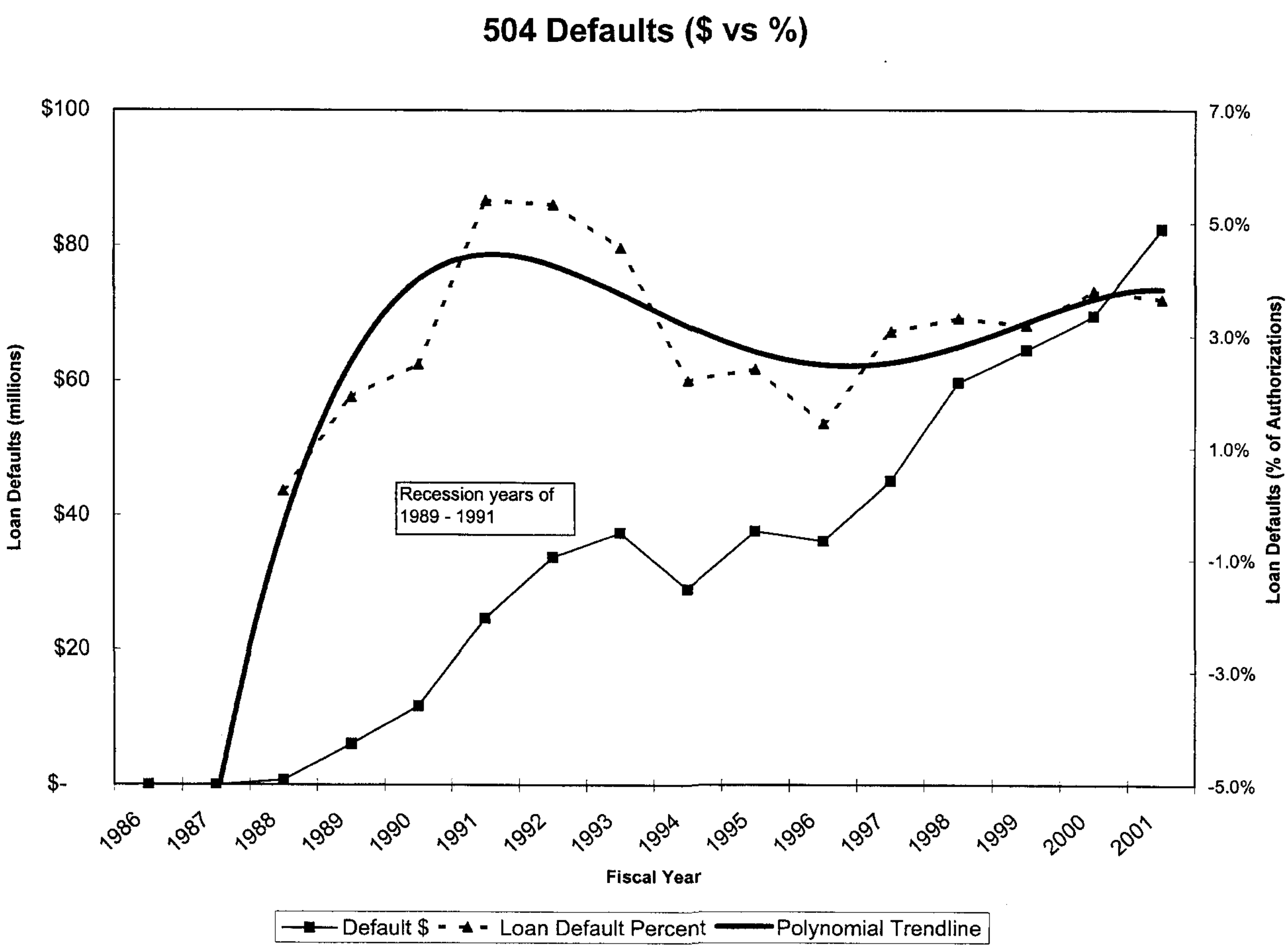
504 Defaults ($ vs %)
$100
$80
$60
$40
$20
$-
Loan Defaults (millions)
7.0%
5.0%
3.0%
1.0%
-1.0%
-3.0%
-5.0%
Loan Defaults (% of Authorizations)
Recession years of 1989 - 1991
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
Fiscal Year
Default $
Loan Default Percent
Polynomial Trendline

CHART 3