U.S. Small Business Administration

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

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

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Thank you, Chairman Kim, Ranking Member Hern, and members of the subcommittee for inviting me to discuss with you the Fiscal Year (FY) 2020 budget proposal for SBA's 7(a) loan program.

In my testimony, I want to outline our credit subsidy model, our annual process to update and execute the model, as well as the options we have for operating the program in FY 2020. This will help provide context to the projection of a positive subsidy rate for the 7(a) program in FY2020 under current law, and the options for Congress to consider in order for the agency to operate at a $30 billion program level.

Credit Subsidy Model

The credit subsidy model is a series of processes and calculations that use historical program data and macroeconomic projections to generate the expected cash flows for the entire life of a cohort. For the sake of clarity, a cohort is the group of loans approved in a given fiscal year.

Annual Process to Update and Execute the Model

Annually, we update our model with the most recent year of 7(a) loan data and macroeconomic indicators. This data results in updates to the three main inputs into the model: performance assumptions, cohort composition assumptions, and macroeconomic assumptions. The model is thoroughly reviewed by the agency, then by an outside auditor, and eventually by the Office of Management and Budget.

Performance Assumptions

We use the performance assumptions to project prepayments, purchases, and recoveries on purchases. We develop the performance assumptions using over 25 years of historical 7(a) program and macroeconomic data. Annually, we test the predictive ability of the existing assumptions and adjust the methodology as necessary to appropriately capture program performance. Our performance assumption methodologies evolve as the 7(a) program and the macroeconomy changes, and as more data is available to us for analysis.

Cohort Composition Assumptions

The cohort composition assumptions are what we assume the characteristics of the loans approved in the budget year will be. We develop the cohort composition assumptions by reviewing the cohort characteristics from recent years and using that information to inform our assumptions for the current cohort. These characteristics include the distribution of loans by region, industry, loan size, maturity term, 7(a) subprogram, and several other factors that impact the cost of the program.

Our model projects a range of costs for a loan depending on the loan's characteristics. As the portfolio changes each year, we are mindful to consider these changes when developing our subsidy rate. We use the most recent data and work with staff from the program office to develop reasonable assumptions for the cohort we are formulating.

Macroeconomic Assumptions

We use macroeconomic assumptions provided by the Office of Management and Budget (OMB). Our portfolio is very sensitive to changes in macroeconomic conditions and the model uses assumptions for interest rates, unemployment rates, and GDP growth rates to develop the subsidy rate estimate.

We update the cash flow model with each of these sets of inputs to develop our subsidy estimate. For the past several years, after updating the inputs, we estimated that the fees we would earn from the loans would be adequate to cover the expected losses, and in fact, in excess of what we would need to cover losses. This allowed us to offer various forms of fee relief. For the loans we expect to approve in FY 2020, we no longer estimate that their fees will be sufficient to cover the expected losses.

Steps Forward

In order to operate our 7(a) program in FY 2020, SBA will need either a subsidy appropriation, or an adjustment to the fee rates. The agency presented three options for Congress to consider to support $30 billion in 7(a) loans. The first option would involve a subsidy appropriation of $99 million. The second option involves statutory changes to the fee structure in order to maintain zero subsidy, and the third option involves a combination of statutory changes to the fee structure and an offset to the agency's administration costs, also to maintain zero subsidy.

The fee rates we propose in the budget, including an attempt to minimize any impact on smaller loans, are as follows:

- Increase the ongoing fee for loans over $1.5 million to 0.69%, from 0.55%;
- Increase the upfront fee for loans over $1.5 million to 3.75%, from 3.5%;
- Increase the upfront fee for loans $500,001 to $700,000 to 3.5%, from 3.0%;
- Increase the upfront fee for loans with a maturity of one year or less to 0.5% from 0.25%.

In conclusion, the agency annually reviews the model's predictive ability and revises performance assumptions when appropriate. We develop assumptions for portfolio composition and update the model with the most recent economic assumptions. This year, this process resulted in a positive subsidy rate after setting fee rates to their statutory maximum and removing all fee waivers.

Thank you again, Mr. Chairman, for inviting me to testify today. I look forward to answering any questions you may have.