No.2
August 2007

MERCATUS ON POLICY

BANKING ON THE SBA

Big banks, not small businesses, benefit the most from SBA loans programs

By Veronique de Rugy

MERCATUS CENTER
GEORGE MASON UNIVERSITY

In 1953, Congress created the SBA to fix a specific problem: Lenders allegedly passed over large numbers of small businesses that, if given loans, would generate untapped economic growth. Assuming that this was a problem in 1953, the problem no longer exists.[1] Moreover, the SBA loan program is not currently doing much to generate a good economic return or help small businesses.[2]

Yet, in FY2008, the Small Business Administration (SBA) will guarantee $28 billion in loans. That's because the SBA serves two powerful constituencies: lawmakers who have successfully sold the SBA as a program to help the so popular small businesses and the banking industry, which profits by issuing and selling the low-risk, government-guaranteed small-business loans.

HOW DO SBA LOAN PROGRAMS WORK?

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

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

HOW DO BANKS BENEFIT FROM SBA LOAN PROGRAMS?

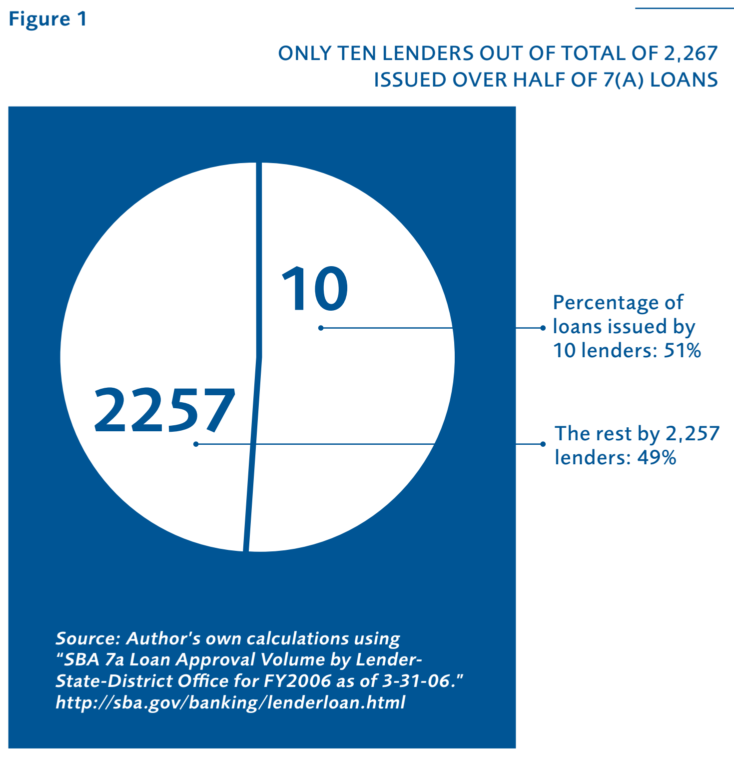
First, when a small business defaults on its obligation to repay an SBA loan, the bank does not bear most of the cost, the taxpayers do. Thus, even though SBA borrowers are riskier than others, the downside risk to the bank is at most 25 percent of what it would be were the loan not guaranteed by the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

> The SBA loan business "…is a higher-end business [to lenders] because it has got a Federal guarantee to it."
> *Sen. Tom Coburn*

Second, under normal circumstances, banks would not issue loans to the small businesses in the 7(a) program, because the high risk of default on the loans means that banks would not profit on the loans.[6] But with the government guarantee of these loans, banks can "earn" normal returns on SBA loans. According to David Bartram—chairman of the National Association of Government Guaranteed Lenders (NAGGL), a national trade organization comprised primarily of lenders participating in the 7(a) guaranteed loan program, and president of the SBA Division of US Bancorp, the nation's sixth-largest financial services company—"we can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly."[7]

Figure 1

ONLY TEN LENDERS OUT OF TOTAL OF 2,267 ISSUED OVER HALF OF 7(A) LOANS



Source: Author's own calculations using "SBA 7a Loan Approval Volume by Lender-State-District Office for FY2006 as of 3-31-06." http://sba.gov/banking/lenderloan.html

Third, through the SBA's Secondary Market Program, lenders have another way to reduce their risk even further and also to increase their lending capability.[8] Lenders pool the guaranteed portions of SBA loans and then sell to investors trust certificates that represent claims to the cash flows. In other words, the guaranteed portions of the loans are turned into tradable securities or "securitized."

Generally, securitization involves grouping assets—such as residential mortgages or car loans—into large pools that are sold as securities to investors. The originator of the security will often offer loss protection to enhance the credit rating of the security. Lenders benefit from the increased liquidity and asset diversity; borrowers may benefit from lower financing costs; and investors benefit from greater liquidity and lower risk than if they had invested in the loans directly.[9]

To encourage a secondary market, Congress passed a law in 1984—the Small Business Secondary Market Improvement Act—that reduced regulatory barriers for the securitization of small business loans.[10] Under this law, SBA provides a secondary guarantee of the trust certificates—guaranteeing timely payments on the certificates if the borrowers' payments are late. According to the Congressional Budget Office, through the Secondary Market Guarantee Program, SBA is taking on risk in addition to the initial guarantee of payment of the principal and interest in the event that borrowers default and the agency purchases the loans.[11] That additional guarantee makes the securities more valuable to investors, who are, as a result, willing to pay more for them.

The data confirms that point. Small business loans are typically not good candidates for securitization. Because the loans' terms vary so much, their underwriting tends not to be standardized, and their risk requires such a high degree of credit enhancement, securitization becomes unprofitable. But SBA-guaranteed loans do not have these problems, and most of the small business loans that have been securitized are SBA 7(a) guaranteed loans. From 1994 to 2001, over 40 percent of the guaranteed part of all 7(a) loans was securitized. By contrast, slightly less than 10 percent of the unguaranteed portion of 7(a) loans was securitized. The advantage of the SBA guaranteed loans is clear: between 1994 and 2001, almost $22 billion of SBA guaranteed loans was securitized, while only about $4 billion of conventional small business loans was securitized.[12]

And this is done at low cost to lenders since under current law. The SBA charges no fee for the 100 percent secondary market guarantee. Only if the loan is sold for more than 110 percent of the outstanding principal balance is half of the excess paid to SBA.[13]

Table 1

ON SBA LOAN*	RETURN ON ASSETS (%) 5 OR MORE	RETURN ON EQUITY (%) 70 OR MORE
CITIGROUP	1.31	18.36
BANK OF AMERICA	1.44	16.56
JPMORGAN CHASE	0.99	11.48
WELLS FARGO	1.76	19.44
WACHOVIA	1.28	14.26

Source: Yahoo Finance, as of January 8, 2007
*Coburn, Tom (2006). "The Effectiveness of the Small Business Administration," Hearings before the U.S. Senate Committee on Homeland Security and Governmental Affairs.

HOW PROFITABLE ARE 7(A) LOANS TO BANKS AND LENDING INSTITUTIONS?

The National Association of Government Guaranteed Lenders (NAGGL) website, a member-only site, states that "return on assets of SBA loans can easily exceed 5 percent, and return on equity can exceed 70 percent."[14] While return on assets is a poor measure of profitability, return on equity is not. Return on equity (RoE) reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. A 70 percent RoE is remarkably high. As of January 8, 2007, the RoEs for the two biggest banks in America—Citigroup and Bank of America—were 18.36 percent and 16.56 percent respectively (Table 1).[15] Even the credit card company American Express, which enjoys a higher return because it requires fewer assets than commercial bank to conduct its business, doesn't show such incredible return on equity. In January 2007, its RoE was 34.2 percent.[16]

In a Congressional hearing, NAGGL's chairman confirmed these numbers and explained that "if you were to sell the SBA guarantee portion, now you have only 25 percent of direct exposure on your bank's books [...] so that is the reason why there is a leveraging power there. That is the reason why the loan can be profitable." He also noted that non-SBA loans weren't as profitable. As explained during the hearing, because of the federal guarantee, SBA loan business is a higher-end business to lenders.[17]

Who are the recipients of these sky-high returns? Reviewing a representative sample of 2,267 7(a) loan lenders, the FY2006 data shows that the sample 7(a) lenders issued 97,290 loans,[18] for a total of $14.5 billion of which SBA guaranteed $10.2 billion or approximately 70 percent. The top ten banks in the United States issued 51 percent of the 7(a) loans. Expand the list to the top twenty banks in the United States and the percentage rises to 65 percent.[19] Bank of America leads the list of institutions. Others on the list are J.P. Morgan Chase, Wells Fargo & Co., and Capital Financial. (Figure 1) The biggest banks in America are the ones benefiting the most from the SBA loans programs.

PRIVATE PROFITS, PUBLIC LOSSES

Banks benefit, but the taxpayer pays. Because the SBA guarantees such a high percentage of the loan amount, banks have little incentive to evaluate loan applicants thoroughly, and the SBA applies little oversight. The SBA's Office of the Inspector General (OIG) has repeatedly warned that the SBA needs to improve its oversight of lenders to minimize the risk of default, waste, and fraud. [20] The OIG recently found that during the first half of FY 2006, 43 percent of SBA purchased guarantees were made inadequately. As a result of this data, the OIG projects that SBA erroneously distributed $36 million in loans, a rate of about 17 percent.[21]

> "We can be as profitable in a 7(a) loan program as we are in our conventional lending if done correctly."
>
> *David Bartram, president of the SBA Division of US Bancorp*

The Government Accountability Office echoes these concerns, pointing out that if the economy were to plunge suddenly, 7(a) loans borrowers would increasingly default on their loans, forcing taxpayers to send large sums of money to SBA banks. As of last year, these guarantees represent some $83 billion in potential taxpayer liabilities, a risk that banks would otherwise assume.[22]

CONCLUSION

Lawmakers sell the SBA loan program as a program that helps small business, an important and popular institution in the United States. In reality though, the SBA loan program is a form of corporate welfare for America's biggest banks. The banks reap profits from this program, but the taxpayers have much to loose. As of the end of 2006, the SBA had nearly $83 billion in outstanding guaranteed loans that the taxpayers—

not the banks—would have to pay if the economy experienced a serious downturn.[23]

SBA's policies should be about helping small businesses, not helping the people who help small businesses, especially at the taxpayers' expense. To that end, the SBA should reduce the federal guarantee on the SBA loans as banks should have the highest share of the risk and costs of SBA loans. If banks' exposures to risk were bigger, then lenders would have an incentive to evaluate loan applicants better; this would then decrease the SBA default rate. Imposing an annual charge on the outstanding guaranteed principal for SBA's new secondary market guarantees would also reduce the risk that taxpayers bear. On the basis of the loan volume reported by SBA in 2006, Congressional Budget Office suggested that a 10 percent charge would increase federal offsetting collections by $27 million over five years.[24] This charge would provide SBA with funding to cover the default costs.

ENDNOTES

1. Veronique de Rugy, *Why Small Business Administration's Loan Programs Should Be Abolished* (Washington, DC: American Enterprise Institute, 2006); Government Accountability Office, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*, GAO-07-769, A Report to the Ranking Member, Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs (2007).
2. Veronique de Rugy, *Why Small Business Administration's Loan Programs Should Be Abolished* (Washington, DC: American Enterprise Institute, 2006); Government Accountability Office, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance*, GAO-07-769, A Report to the Ranking Member, Subcommittee on Federal Financial Management, Government Information, Federal Services, and International Security, Committee on Homeland Security and Governmental Affairs (2007).
3. The SBA criteria for a 7(a) loan are very broad. An applicant must be a for-profit enterprise without the internal resources necessary to finance its activities. It must be able to demonstrate capacity to repay the loan, and it must be considered a small business by the SBA. As the SBA defines a small business as a firm with less than 500 employees, almost all U.S. firms are "small." (A comprehensive definition of small businesses across industries can be found at www.sba.gov.) According to the SBA's Office of Advocacy, small businesses represent 99.7 percent of all employer firms in the United States. SBA Office of Advocacy, "Frequently Asked Questions," http://app1.sba.gov/faqs/faqindex.cfm?areaID=24.
4. "Suitable terms" is a subjective assessment by the SBA lender. Even if it could get capital from a private lender, a small business can get a SBA loan so long as the SBA lender (which may even be the same bank to which the business applied for a private loan) assesses that the conditions of the private loan would be "burdensome." Because of the high probability of failure, most risky projects are likely to have private loans offered at "burdensome" terms.
5. See Small Business Administration, "SBA's Role—Guaranty Percents," http://www.sba.gov/services/financialassistance/basics/sbarole/serv_7a_guarantyperc.html.
6. David Bartram, *Testimony before the Subcommittee on Federal Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, Effectiveness of the Small Business Administration: Hearing before the Subcommittee on Federal Financial Management, Government Information, and International Security*, 109th Cong., 2d sess., 2006, 38.
7. Ibid., 37
8. Thomas McCool, *Testimony before the Subcommittee of Government Programs and Oversight of the House Small Business Committee, Small Business Administration: Secondary Market for Guaranteed Portions of 7(a) Loans*, (Washington, DC: Government Accountability Office, 1998), 5, http://www.gao.gov/archive/1998/gg98184t.pdf.
9. Board of Governors of the Federal Reserve System, *Report to Congress on the Availability of Credit to Small Businesses*, 107th Cong., 2nd sess. (Washington DC, 2002): 57-62, http://www.federalreserve.gov/boarddocs/RptCongress/sbfreport2002.pdf.
10. Thomas McCool, *Secondary Market*, 5.
11. Congressional Budget Office, "Impose fees on the Small Business Administration's Secondary Market Guarantees," Budget Option, Commerce and Housing Credit, 103.
12. Federal Reserve, *Availability of Credit to Small Businesses*, 60.
13. Congressional Budget Office, "Impose fees,"103.
14. Senator Tom Coburn, Subcommittee on Federal Financial Management, Government Information, and International Security of the Senate Committee on Homeland Security and Governmental Affairs, *Effectiveness of the Small Business Administration: Hearing before the Subcommittee on Federal Financial Management, Government Information, and International Security*, 109th Cong., 2d sess., 2006, 39.
15. Yahoo Finance, as of January 8, 2007
16. Yahoo Finance, as of January 8, 2007
17. Coburn, *Effectiveness of the Small Business Administration*, 39.
18. According to the National Small Business Association, the number of SBA lenders was 2,751 in fiscal 2006.
19. Author's calculation based on SBA 7(a) Lenders List provided by the SBA.
20. Office of the Inspector General of the Small Business Administration, "FY 2006 Report on the Most Serious Management Challenges Facing the Small Business Administration, Report No. 6-02," *The Small Business Administration FY 2005 Performance and Accountability Report* (Washington DC, 2005): Appendix 5, http://www.sba.gov/2005PAR.pdf/docs/335_Appendix5.pdf.
21. Office of the Inspector General of the Small Business Administration, *Audit of the Guarantee Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center, Report No. 7-23* (Washington, DC, 2007), http://www.sba.gov/ig/7-23.pdf.
22. Zachary Kalman and Douglas J. Elliott, *The Small Business Administration: A Primer* (Washington, DC: The Center on Federal Financial Institutions, 2006): 11.
23. Ibid.
24. Congressional Budget Office (2007), "Increase Fees On The Small Business Administration's Secondary Market Guarantees," *Budget Options*, p. 103.

The Mercatus Center at George Mason University is a research, education, and outreach organization that works with scholars, policy experts, and government officials to connect academic learning and real world practice.

The mission of Mercatus is to promote sound interdisciplinary research and application in the humane sciences that integrates theory and practice to produce solutions that advance in a sustainable way a free, prosperous, and civil society.

Veronique de Rugy is a senior research fellow at the Mercatus Center. Her research interests include federal budget, homeland security, tax competition, and financial privacy issues. She holds a PhD in economics from the University of Paris-Sorbonne.