Small Business, Banks and SBA Loan Guarantees: Comment

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An earlier volume of this Journal (Latona, 1989) carried a review of Elizabeth Holmes Rhyne's *Small Business, Banks and SBA Loan Guarantees* (Quorum Books, 1988). The reviewer concludes that the "book is a pillar study and should become a reference for all small business advocates."

While I agree that there is merit to be found in the book, the reviewer fails to cite the significant factual errors that mar an otherwise competent effort and give a misleading impression of the role of the SBA's loan guaranty program in the U.S. economy. Rhyne addresses the issue of program rationale in Chapter 5.[1] In my view, the most important program goal is to correct for imperfections in the business credit markets.

The author argues that "it is crucial to the credit market gap explanations of the program's purpose that small businesses be disadvantaged in credit markets not through any fault of their own, but simply because of the inability of financial institutions to cope with their size or their maturity needs . . . In other words, the portfolio should require no subsidy for default losses" (p. 95).

The author calculates that "defaults require a 9 percent subsidy from SBA, or 11 percent, if SBA's administrative expenses are included" (p. 96). Another calculation is that "SBA loans are ten times more likely to default than private ones" (p. 63).

There are a number of problems with these conclusions.

First, what is really important is not the default rate but the loss rate. A default means the borrower stops paying. A loss is what may result if a defaulted loan has to be liquidated and charged off on the lender's books. A loan could default and if it is fully secured the collateral would be sold for at least the amount of the balance and the loss would be zero. Neither the bank nor the taxpayer would lose a dime.

A look at loss rates instead of default rates reveals a different picture from the one painted in the book. In 1987, the year before the book was published, the net loss rate on SBA guaranteed general business loans (net chargeoffs divided by outstanding portfolio) was 3.7%. In comparison the net loss rate on all commercial and industrial loans by banks in 1987 was 1.2% (Federal Deposit Insurance Corporation, 1987). The difference is a factor of three, not ten.

Second, there is a significant difference between the way SBA and banks calculate their loss rates. When an SBA loan defaults, the interest accrual clock continues to run until the loan is charged off or paid in full. Any dollars recovered in liquidation are credited first to interest and then to prinipal. Most banks stop accruing interest shortly after a loan enters a nonpaying status. This difference in accrual practices may have a significant effect on the loss rates reported by SBA and by banks.

Third, Rhyne's calculations are based on an analysis of loans with a seven year maturity. Loans with maturities of seven years or less are expected to have the highest loss rates of all SBA loans. Many are for working capital only and are not as well secured as longer-term loans, which typically finance fixed assets in addition to working capital. Seventy-six percent of the guaranteed loan portfolio has a maturity greater than seven years. Basing subsidy analysis on seven year loans imparts an upward bias to the subsidy estimate.

Fourth, the Rhyne analysis is flawed by failure to consider all revenues that are generated for the Federal Treasury by the SBA loan. She considers as revenue only the loan guaranty fee. (She applies

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it erroneously to the lender. Actually, it goes to the U.S. Treasury.) She fails to consider the Treasury revenues produced by the additional taxes paid by SBA loan recipients.

There is ample evidence (GAO, 1983; National Survey of Small Business Finance, 1989) that SBA-type loans would not have been made were it not for the SBA guarantee. How does this affect the Rhyne calculations?

Let us consider an extreme case to illustrate the point most clearly. Imagine that the program consists of two $500,000 loans. One of the loans defaults, resulting in a net loss of $250,000. The other loan is eventually paid in full. According to Rhyne's methodology, the loss rate is 25% ($250,000 divided by $1 million). The taxpayer is a big loser and this would appear to have been an unwise expenditure of government funds.

But suppose further that the other firm, the one that did not default, was a runaway success. Assume that the present value of its tax payments to the Treasury attributable to the SBA loan and after consideration of the opportunity costs of the government funds, was $1 million. Wouldn't a taxpayer have a different opinion? If all costs and revenues are considered, the Treasury shows a $750,000 gain, not a $250,000 loss. In principle, Rhyne's failure to consider all revenues accruing to the government is a fatal flaw in her subsidy analysis.

A cost revenue analysis based on survey data reveals that the government income from the 2% guaranty fee and the induced Federal and state tax payments from the firms that received the guaranteed loans compared to SBA's administrative costs and net losses on charged-off loans produces for the Federal Treasury an internal rate of return of 26% per year from the government's investment in SBA guaranteed loans (U.S. House of Representatives, 1989).

All of this evidence contradicts the calculations reported from Rhyne's model and calls into question the conclusion that her analysis "discredits any claim that SBA loans correct a credit market failing" (p. 96).

Another puzzling element of the book is the author's repeated assertion that banks make lots of term loans without the SBA guaranty. If true, this would gainsay a major pillar of the rationale for SBA loans: they permit bank to make long term loans that banks cannot otherwise make. Rhyne asserts that "term loans now account for approximately half of all commercial bank business loans" (p. 19. No source is cited.)

This statement is contradicted by readily available Federal Reserve Board data. (Board of Governors of the Federal Reserve System) In 1986, the terminal year of the Rhyne study, only 12% of commercial and industrial loan dollars from commercial banks had a maturity of one year or more. And of those, only 21% were for less than $500,000, which was the upper limit on the SBA guaranty in that year. In contrast, the average maturity on SBA loans in 1986 was just under twelve years.

Elsewhere, she cites an unnamed survey that 56% of commercial bank loans are to small business and half of these are term loans. (Page 22) Bank records do not provide a breakdown between loans to small and to large businesses. However, the Federal Reserve Board data cited above say that only 3% (12% of 21%) of the commercial bank loan dollars made in 1986 were term loans of the size made possible by the SBA guaranty program.

The book is thought-provoking and raises a variety of interesting issues. However, as with much that we economists do, the questions are better than the answers.

Note

[1] For an alternative view, see Mandel (1990).

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