

Federal Reserve Bank of Cleveland

# Are SBA Loan Guarantees Desirable?

by Ben R. Craig, William E. Jackson, III, and James B. Thomson

The promotion of small businesses is a cornerstone of economic policy for a large number of industrialized countries. Public support for small enterprise appears to be based on the widely held perception that the small business sector is an incubator of economic growth, a place where innovation takes place and new ideas become economically viable business enterprises. In addition, policymakers routinely point to small businesses as important sources of employment growth—even though economic studies find little evidence to support this claim. It is not surprising, then, that there is widespread political support for government programs, tax breaks, and other subsidies aimed at encouraging the growth and development of small business in the United States and, increasingly, around the world.

A particular area of concern for policymakers is whether small businesses have access to adequate credit. Growing businesses have an acute need for credit, but many small firms may have a hard time obtaining it because they are young and have little or no credit history. Lenders may also be reluctant to fund small firms with new and innovative products because of the difficulty associated with evaluating the risk of such products. If small businesses lack a sufficient supply of credit, policymakers should be concerned, for the next Google, Microsoft, or Starbucks might wither on the vine for want of funding. To the extent that some market failure significantly impairs the access small businesses have to credit, a rationale exists for supporting these businesses through government programs aimed at improving their access.

One specific government intervention aimed at improving small firms' access to credit is the Small Business

Administration (SBA) guaranteed lending program. SBA loan guarantees are well established, and their volume has grown over the past decade. Nearly 20 million small businesses have received direct or indirect help from one or another of the SBA's programs since 1953. The SBA's current business loan portfolio of roughly 219,000 loans is worth more than \$45 billion, making it the largest single financial backer of small businesses in the United States. Over the period 1991 to 2000, the SBA assisted almost 435,000 small businesses in obtaining more than \$94.6 billion in loans, more than in the entire history of the agency before 1991. No other lender in this country has been responsible for as much small business financing as the SBA has during that time (SBA, 2004). These lending numbers are remarkable when one considers that SBA loan guarantees are aimed at that segment of small business borrowers that presumably would not otherwise have access to credit.

Is there a market failure that justifies intervention of this magnitude? Many economists believe that credit markets—whose efficient operation depends so heavily on the ease with which lenders can gather information on borrowers—are indeed prone to failure when the nature of the borrowers makes it hard to obtain this information, as is the case with small businesses. To know how well the SBA lending program is addressing that failure (and doing so with no adverse side effects), we also have to be sure we know what the mechanics of the failure are and ask whether the program is designed to target only those areas where the breakdown in natural market forces arises.

**Over the last 10 years, the Small Business Administration has been responsible for well over \$100 billion in small business credit extensions, more than any single private lender. This *Commentary* explores the motivations for such a large investment of taxpayer dollars.**

## ■ The Economics of Credit Markets

The economic justification for any government-sponsored small business lending program or loan guarantee program must rest on a generally acknowledged failure of the private sector to allocate loans efficiently. Absent such a clearly identified problem with private-sector lending to small businesses, the SBA's activities would simply seem a wasteful, politically motivated subsidy to this sector of the economy.

Many economists, most notably Joseph Stiglitz and Andrew Weiss, contend that private lending institutions may indeed fail to allocate loans efficiently because of fundamental information problems in the market for small business loans. These information problems may be so severe that they lead to credit rationing, the allocation of credit by means other than price. Nonprice rationing is a less efficient mechanism for allocating credit than price, and, where it exists, it generally reduces the credit available to the market overall. Credit rationing then constitutes the failure of the credit market. Stiglitz and Weiss claim that rationing is a likely outcome in credit markets with small business borrowers because of banks' difficulty in getting

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is not only to the economic well-being but to the security of this Nation.

*Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect insofar as is possible the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation. [emphasis added]*

—Small Business Act of 1953 (establishing the Small Business Administration)

sufficient information about them. They argue that when banks are deciding whether to make a loan, they are concerned about the interest rate they receive on the loan and the riskiness of the loan. But the imperfect information banks have after evaluating loan applications can cause two things to happen, both of which *allow the interest rate itself to affect the riskiness of the loan pool*. This is the crux of the problem, because when the price (here, the interest rate) affects the nature of the transaction, it is unlikely that a price will emerge that suits either the available buyers or sellers (no price will “clear the market”). The first effect, adverse selection, affects the ability of markets to allocate credit on price because it removes the lower-risk borrowers from the set of potential borrowers. The second consequence, moral hazard, reduces the ability of prices to clear the lending markets by influencing the actions of borrowers.

Adverse selection is a consequence of different borrowers having different probabilities of repaying their loan. The expected return to the bank on a loan obviously depends on the probability of repayment, so the bank would like to be able to identify borrowers who are more likely to repay. Typically, the bank will use a variety of screening devices to do this. The interest rate that a borrower is willing to pay may act as one such screening device. For example, those who are willing to pay a higher interest rate are likely to be, on average, worse risks. These borrowers are willing to borrow at a higher interest rate because they perceive their probability of

repaying the loan to be lower. So, as the interest rate rises, the average “riskiness” of those who borrow increases, and this may actually result in lowering the bank’s expected profits from lending.

Similarly, as the interest rate and other terms of the contract change, the behavior of the borrower is likely to also change. For instance, raising the interest rate decreases the profitability of projects that succeed. Higher interest rates may thus induce firms to undertake projects that are riskier—ones with lower probabilities of success but higher payoffs when successful. In other words, the price a firm pays for credit can affect its investment decision. This is the moral hazard problem.

As a result of these two effects, a bank’s expected return may increase less rapidly than the interest rate and, beyond a point, may actually decrease. Clearly, under these conditions, it is conceivable that the demand for credit may exceed the supply of credit in equilibrium. Although traditional analysis would argue that in the presence of an excess demand for credit, unsatisfied borrowers would offer to pay a higher interest rate to the bank, bidding up the interest rate until demand equals supply, it does not happen in this case. This is because the bank would not lend to someone who offered to pay the higher interest rate, as such a borrower is likely to be a worse risk than the average current borrower. The expected return on a loan to this borrower at the higher interest rate is actually lower than the expected return on the loans the bank is currently making. Hence, there are no competitive forces leading supply to equal demand, and credit is rationed.

SBA loan guarantees should improve credit allocation by providing a mechanism for pricing loans that is independent of borrower behavior. By reducing the expected loss associated with a loan default, the guarantee increases the expected return to the lender—without increasing the lending rate. In the absence of adverse selection, lenders could simply offer borrowers loan rates that reflected the average risk of the pool of borrowers. Each loan made would reflect a random draw from the pool of borrowers, and if the bank made a large number of small loans to borrowers in the pool, then the bank’s loan portfolio would have the same risk and return characteristics of the pool of borrowers. But, as explained, adverse selection increases the average riskiness of the pool to the point where banks are not willing to lend. With the guarantee in place, the lender could profitably extend credit at loan rates below what would be dictated by the risk of the average borrower. The reason for this is that the guarantee increases the profitability of the loan by reducing the losses to the bank in those instances where the borrower defaults.

To the extent that the loan guarantee reduces the rate of interest at which banks are willing to lend, external loan guarantees should help mitigate adverse selection. After all, lowering the lending rate increases the number of low-risk borrowers applying for credit, which, in turn, increases the likelihood that the average risk of firms applying for loans is representative of the pool of borrowers. Moral hazard behavior is also mitigated because the lower lending rates afforded by external guarantees reduce the bankruptcy threshold and thereby increase the expected return of safe projects vis-à-vis riskier ones. Thus, in theory, SBA loan guarantees should reduce the probability that a viable small business is credit rationed.

### ■ Small Business Administration Loan Guarantee Programs

The legislation that created the Small Business Administration, the Small Business Act, was enacted on July 30, 1953. By 1954, the SBA was already making direct business loans and guaranteeing bank loans to small businesses, as well as making loans to victims of natural disasters, working to get government procurement contracts for small

businesses and helping business owners with management and technical assistance and business training. Recognizing that private financial institutions are typically better than government agencies at deciding which small business loans to underwrite, the SBA began moving away from making direct loans and toward guaranteeing private loans in the mid-1980s. Currently, the SBA makes direct loans only under very special circumstances. Guaranteed lending through the SBA's 7(a) guaranteed loan program and the 504 loan program are the main form of SBA activity in lending markets.

The 7(a) loan program is the more basic and more significant of these two programs. Its name comes from Section 7(a) of the Small Business Act, which authorizes the agency to provide business loans to American small businesses. All 7(a) loans are provided by lenders who are called participants because they participate with the SBA in the 7(a) program. Not all lenders choose to participate, but most American banks do, as well as a number of nonbank lenders. This expands the availability of lenders making loans under SBA guidelines.

Loans made through the 7(a) program are available only on a guarantee basis. This means that they are provided by lenders who choose to structure their own loans according to the SBA's requirements and who apply for and receive a guarantee from the SBA on a portion of this loan. The SBA does not fully guarantee 7(a) loans. The SBA guarantee is usually in the range of 50 percent to 85 percent of the loan amount, and the maximum guarantee is \$1,000,000. The lender and the SBA share the risk that a borrower will not be able to repay the loan in full. The guarantee is a guarantee against payment default and does not cover other contingencies, such as imprudent decisions by the lender (such as underpricing of the loan, failure to enforce loan covenants, or failure to perfect a lien on collateral) or misrepresentation by the borrower.

The 504 loan program is a long-term financing tool for economic development within a community. The 504 program provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land or

buildings, through a certified development company (CDC). A CDC is a nonprofit corporation set up to contribute to the economic development of its community. CDCs work with the SBA and private-sector lenders to provide financing to small businesses. There are about 270 CDCs nationwide. Each CDC covers a specific geographic area (SBA, 2004).

Typically, a 504 project includes a loan from a private-sector lender, covering up to 50 percent of the project cost, a loan from the CDC (backed by a 100 percent SBA-guaranteed debenture), covering up to 40 percent of the cost, and a contribution of at least 10 percent equity from the small business being helped. The SBA-backed loan from the CDC is usually subordinate to the private loan, which has the effect of insulating the private lender from loss in the event of default. Generally, a business must create or retain one job for every \$50,000 provided by the SBA. The maximum SBA debenture is \$1,000,000 for meeting the job creation criteria or a community development goal and \$1,300,000 for meeting a public policy goal. Current public policy goals recognized by the SBA are business district revitalization, expansion of exports, expansion of minority business development, rural development, enhanced economic competition, restructuring because of federally mandated standards or policies, changes necessitated by federal budget cutbacks, expansion of small business concerns owned and controlled by veterans, and expansion of small business concerns owned and controlled by women (SBA, 2004).

#### ■ Proper Program Design

Ensuring access to credit has been an important pillar of public support for small business for more than half a century. Over the last 10 years, the SBA has been responsible for well over \$100 billion in small business credit extensions, more than any single private lender. Of course, this is what the SBA was created to do. The agency's primary mission as set forth by Congress is to assist small businesses in their quest for credit on reasonable terms. Properly structured loan guarantee programs that work through existing credit channels, as is the case with the majority of the SBA's programs, are more likely to produce results consistent with growth-oriented public policy objectives than direct lending programs.

#### ■ Recommended Reading

Ben R. Craig, William E. Jackson, III, and James B. Thomson, 2004. "On SBA Guaranteed Lending and Economic Growth," in *Government-University Partnerships to Enhance Economic Development Through Entrepreneurship*, Edward Elgar Publishing (forthcoming).

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