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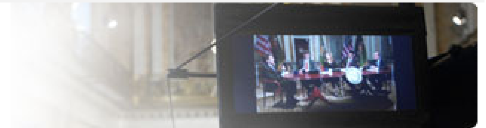

Written Testimony by Counselor Gene Sperling before the Committee on Financial Services on “Initiatives to Promote Small Business Lending, Jobs and Economic Growth”

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TG-703

Chairman Frank, Ranking Member Bachus, Members of the Committee, I appreciate the opportunity to discuss the topic of small business lending and job creation today.

There are few things as important for a strong recovery as ensuring that small businesses have the ability to access credit, make investments and create new jobs. One of the brutal facts of the financial crisis is that the actions of the irresponsible have hurt so many innocent Americans who did act responsibly– including hundreds of thousands of small business owners across the country. As Secretary Geithner wrote last year, the decisions that led to the financial crisis "have caused enormous suffering, and much of the damage has fallen on ordinary Americans and small-business owners who were careful and responsible. This is fundamentally unfair, and Americans are justifiably angry and frustrated." Secretary Geithner and the Administration recognize that the continued challenges small businesses face in accessing the credit they need to keep their businesses afloat or expand as the economy improves are not only unjust, but also work against the kind of recovery we need to create jobs again.

Indeed, during the past recession, small business employment went down less than employment at larger firms, and then began growing faster during the recovery. In this recession, however, smaller firms have struggled more than larger firms to gain jobs. Data analyzed by Treasury's Assistant Secretary for Economic Policy and Chief Economist Alan Krueger reveals that between July 2009 and February 2010, establishments with fewer than 50 employees lost, on average, 158,000 jobs a month, while establishments with more than 250 employees gained about 32,000 jobs a month.

As the National Federation of Independent Business' monthly survey of small businesses shows, the number one economic concern facing small businesses is poor sales stemming from a lack of demand from consumers – with 29 percent reporting in April that it was their most important problem. But beneath this headline is the clear fact that many small businesses – including many of those who are also struggling due to poor sales – want to borrow, but cannot. According to a special NFIB supplement on credit published this February, among small businesses that sought to borrow last year, 45 percent were unable to get all the credit they wanted. Similarly, the National Small Business Association reported that 39 percent of small businesses were not able to get adequate financing. This suggests that even as the recovery emerges and sales pick up, creditworthy small businesses may struggle to expand and create jobs because they are unable to borrow.

Since before the day the President took office – at a point when the alarming extent of the credit crunch for small businesses had become very clear – this Administration has sought to put forward a comprehensive agenda to ensure small businesses could borrow, expand and create jobs. We started with tax cuts, including provisions in the Recovery Act that allowed small businesses to write off up to $250,000 in investments, carry back their net operating losses five years, use "bonus depreciation" to accelerate the rate at which they can deduct the cost of capital expenditures, and have 75 percent of capital gains on qualified small business investments excluded from taxation. In addition, through the Making Work Pay tax credit, the vast majority of small business owners received a tax cut.

At the beginning of this Administration, Treasury and SBA also worked together to address a severe decline in SBA lending. While annual SBA loan volume in recent years had been about $20 billion per year, at the beginning of 2009, SBA lending was on pace to potentially fall below $10 billion. The secondary market on which SBA loans are bought and sold had frozen, removing a key source of liquidity that allowed banks to extend new credit. As a result, we recognized we would need a coordinated response of strong measures to jumpstart SBA lending through the Recovery Act, combined with a commitment to unfreeze the secondary market--which many banks rely on for liquidity to make new 7(a) loans. Treasury worked with the Small Business Administration to secure passage of higher guarantees for qualifying 7(a) loans and reduced fees for both 7(a) and 504 loans under the Recovery Act, while announcing an effort to directly purchase securities backed by SBA loans and improving the terms under the Term Asset-Backed Securities Loan Facility to help unlock the secondary market.

These efforts had their intended effect. By creating confidence that there would be a buyer of last resort, the improved terms for securities backed by SBA loans under TALF, combined with the March 2009 announcement of the SBA securities purchase program, helped to unfreeze the secondary market. Indeed, some market participants noted that the simple announcement of these efforts had a positive impact in restarting the market. In January and February 2009, the volume of loans settled from lenders to broker-dealers on the secondary market for SBA loans averaged $112 million – about one-third of the 2008 pre-crisis average of $328 million. By May 2009, activity had returned to $325 million, and monthly volume since has averaged $336 million. Combined with the Recovery Act provisions increasing guarantees and reducing fees – implemented under the leadership of SBA Administrator Karen Mills –these improvements have helped SBA weekly loan volumes increase by over 90 percent relative to the weeks before the Recovery Act passed and encouraged nearly 1,300 lenders that had not made a SBA loan since 2007 to do so.

In the months since, we have continued to take action to support small business job creation. The comprehensive health reform that passed as part of the Affordable Care Act included a Small Business Health Care Tax Credit – effective immediately – that will help small businesses afford the cost of covering their workers, saving smaller firms $40 billion by 2019. At the same time, health care reform will, by 2014, allow firms with 100 or fewer workers to pool their purchasing power. These policies will also reduce the unfair burdens these employers face in the small group market and lower administrative costs by allowing them to buy insurance through an exchange, while bringing down the cost of treating the uninsured that adds a "hidden tax" of over $1,000 to every family's health care premium.

We have also worked with Congress to pass additional tax relief for small businesses to encourage job creation and investment. As part of the HIRE Act signed into law earlier this year, the Administration extended Recovery Act expensing provisions for small businesses that increased the amount of capital expenditures small businesses could write off to $250,000, while creating a new tax credit for businesses that hire and retain workers that were previously unemployed.

More broadly, by stabilizing the financial system, the efforts taken under TARP prevented what might otherwise have been a more severe contraction in credit to small businesses and a much deeper recession. Among smaller banks – which have generally maintained lending to a much greater degree than their larger counterparts, and are the most focused on small business lending – those that participated in the Capital Purchase Program (CPP) outperformed those that did not with respect to lending. Treasury's analysis of Call Report data finds that for banks with assets less than $1 billion, the median growth of total loans for CPP banks from the third quarter of 2008 to the fourth quarter of 2009 was 4.1 percent, compared to a median rate of 2.3 percent among non-CPP banks. Likewise, the efforts to stabilize the financial system and stimulate a recovery – which helped an economy that had contracted at an average annual rate of -5.9 percent in Q42008/Q12009 shift to an average annual growth rate of 4.4 percent during the past two quarters – prevented what would have been a much steeper decline in lending and in sales for small businesses.

Yet while these measures have certainly made conditions for small business significantly better than they would have been in their absence, the President and his economic team believe that credit availability remains a serious problem requiring significantly more to be done. According to the Federal Reserve Senior Loan Officer Opinion Survey, lenders reported 13 straight quarters of net tightening loan standards for small firms prior to last quarter, when they reported no net tightening or loosening – an improvement, but one that suggests that lending remains constrained given the prolonged tightening over the course of the crisis. The pullback in lending among larger banks has been particularly disappointing – especially, as the President said in December, since " given the difficulty businesspeople are having as lending has declined, and given the exceptional assistance banks received to get them through a difficult time, we expect them to explore every responsible way to help get our economy moving again." And while large businesses have also been impaired by these credit constraints, this tightening has had a more significant impact on small businesses. Large businesses rely on banks for only 30 percent of their financing. Many have been able to access other sources of credit and benefit from the recovery in the corporate bond market. Small businesses, on the other hand, rely on banks for 90 percent of their financing, leaving them with few alternatives as lenders tighten their standards. Indeed, the combination of constrained credit conditions, reduced sales and declines in the value of real estate collateral has led many small businesses to face a "perfect storm" that continues to hinder their ability to grow and create new jobs.

Throughout 2009, the Administration continued to explore additional ways to use Treasury's authority under TARP to support lending to small businesses. Unfortunately, we found that fear of stigma and retroactive punitive measures made community and smaller banks increasingly unwilling to take part in any TARP program. Indeed, we started seeing this trend even earlier in 2009, when over 600 banks withdrew their applications to participate in the CPP – many citing these concerns about TARP stigma or retroactive restrictions. This fear of becoming a TARP recipient became even more pronounced last November when Congress chose to disqualify any bank that had participated in TARP from receiving the benefits of net operating loss carrybacks.

The sole exception appeared to be Community Development Financial Institutions. Because they alone stressed to us that they were willing to participate in a TARP facility, Treasury moved forward with the new Community Development Capital Initiative (CDCI). The results so far have been very encouraging, as we understand well over 100 banks, thrifts and credit unions have applied to their regulators to participate in the CDCI program since it was launched earlier this year.

We have also put serious work into exploring whether there would be a way to use TARP funds to help small businesses – outside of CDFIs – without requiring that small banks be labeled "TARP recipients." However, after much effort and consideration, we determined we had no choice but to seek new legislation to enable us to help the flow of small business credit -- and in turn, small business expansion and job creation -- through efforts completely outside of and separate from TARP. In that light, the Administration has sought to work with Congress to pursue a comprehensive small business jobs package that would include the following elements:

1) Additional tax incentives to encourage small business investment, including a 100% elimination of capital gains taxes on certain small business investments

2) A temporary extension of successful Recovery Act provisions that increased SBA guarantees and eliminated fees

3) An expansion of SBA loan products, including an increase in the maximum loan size of loans under the 7(a), 504 and microloan programs and an expansion of refinancing of owner-occupied commercial real estate under the 504 program

4) New proposals we are discussing with Chairwoman Nydia Velazquez to strengthen programs at the SBA that bring creditworthy small business borrowers off the sidelines and support financing for small businesses, including those in their earliest stages of growth

5) An expansion and improvement of the New Markets Tax Credit (NMTC) to support lending in the hardest-hit communities as proposed in the Administration's budget – by extending the NMTC through 2011 with $5 billion in authority, allowing the NMTC to offset the Alternative Minimum Tax (AMT) to put it on equal footing with other similar credits, and enhancing the credit so it works better for small businesses

6) The creation of a new Small Business Lending Fund that would invest capital in community and smaller banks with strong built-in incentives to increase lending

7) A new State Small Business Credit Initiative that would strengthen innovative state programs, supporting $10 in small business lending for every $1 in Federal funding

Today, I'd like to discuss these last two provisions at greater length.

First, the Administration earlier this year put forward a proposal to create a new $30 billion Small Business Lending Fund. This fund – which would be established entirely separate from TARP – would provide capital to community and smaller banks whose commercial lending is already concentrated among smaller loans, structured with incentives to increase that lending. By providing $30 billion in capital to these banks, the fund could support several multiples of that amount in new lending. However, I want to focus in particular on five key features of the fund and its design that we believe will make it a cost-effective means of supporting small business lending:

1) ***The Program Is Limited to Smaller Banks That Traditionally Focus Their Business Lending on Small Businesses:*** As designed, the program would be open only for banks with less than $10 billion in total assets – with the fund providing up to 5 percent of risk-weighted assets to banks smaller than $1 billion in total assets, and up to 3 percent of risk-weighted assets to banks between $1 billion and $10 billion in total assets. These banks are the lenders most focused on small business lending: among their commercial and industrial (C&I), owner-occupied commercial real estate and farm lending, about two-thirds of their loan volume is extended through the smallest loans. [1]

2) ***The Smaller Banks Targeted By This Program Have Dramatically Outperformed Larger Banks in Maintaining Lending to Small Businesses:*** While smaller banks have unquestionably been challenged by the financial crisis, they have also dramatically outperformed larger banks in maintaining lending to small businesses during the crisis. For instance, as the chart below illustrates, commercial and industrial (C&I) and commercial real estate lending at banks with less than $1 billion in assets grew at an average annual rate of 3.5 percent for the eight quarters ending with the 4 th quarter of 2009, while lending at banks with more than $10 billion in assets contracted at an average annual rate of 8.1 percent: [2]

3) ***Performance-Based Incentives Target Benefits Only to Those Banks That Increase Lending Over 2009 Levels:*** The dividend rates banks pay on SBLF capital would start at 5 percent, but would be set to provide an incentive to increase lending over a baseline set using 2009 data. This baseline would not only include standard C&I and owner-occupied real estate loans, but also encourage banks to increase lending to farmers and agricultural businesses as well. Lenders could reduce their dividend rate to as low as 1 percent – but only if they increased lending by at least 10 percent over that baseline. This design establishes a clear, reliable metric of measuring changes in lending before and after banks enter the program, while ensuring that the incentives only go to those banks that use capital to extend more credit. At the same time, lenders that receive the lower dividend rate will be able to "pass through" the lower cost of funds to their borrowers by offering reduced rates on new loans – potentially bringing new borrowers off the sidelines so that they can expand and hire new workers.

4) ***In Response to Discussions With Congress, We Have Added A Higher Rate for Institutions That Do Not Increase Lending:*** After consultations with Congress, the proposed Small Business Lending Fund now includes a provision that would increase the dividend rate from 5 percent to 7 percent after two years for any participating bank that does not increase its lending. This new provision increases the "performance-based" nature of the program, offering a further incentive for participants to extend more credit.

5) ***Capital Designed to Ensure Small Banks Do Not Pull Back Lending In Light of Commercial Real Estate Concerns:*** With some community banks anxious about continued challenges in the commercial real estate market, the Small Business Lending Fund is designed to reduce the risk that viable institutions would react to such fears by pulling back indiscriminately on small business lending. By accessing additional capital under the SBLF, institutions can be confident that they can continue to lend and still have a buffer against future CRE losses.

We believe that as designed, the Small Business Lending Fund can attract smaller and community banks to participate in a program that will help them extend more credit. Indeed, we are pleased that this proposal has drawn the support of the Independent Community Bankers of America – represented here today by its chairman James MacPhee – as well as groups like the National Small Business Association, Small Business Majority, the National Bankers Association, the Conference of State Bank Supervisors, as well as the 19 Members who have chosen to sponsor or co-sponsor the legislation.

Secondly, as a new component of our Small Business Lending Fund, we have worked with Congress to put forward a new State Small Business Credit Initiative, which would support state programs that help make credit more available for small businesses and manufacturers.

This new initiative would provide grants to state small business programs – programs that are facing increased demand, even as strained state budgets have reduced their ability to meet that need. Funding would go to state programs that enable private lenders to extend credit to creditworthy small businesses, ensuring that loans are made with sufficient underwriting standards. At the same time, the program would operate with a significant "bang for the buck," as states would be required to support at least $10 of lending across all programs for every Federal dollar received. Congressman Gary Peters and Ways and Means Chairman Sandy Levin have proposed to fund this program at $2 billion – an amount that the Administration supports as part of an overall package that is paid for – and we believe that with such funding, the program could support over $20 billion in lending.

Through this initiative, states could expand a range of innovative small business programs. States could use funds for programs that provide collateral support to small businesses and manufacturers. These programs help support viable businesses that have seen the value of their collateral fall, a problem that has made credit more difficult to get, particularly for small manufacturers in some of the communities hardest-hit by the financial crisis. States like Michigan under Governor Jennifer Granholm and Ohio under Governor Ted Strickland have looked to devote funds to augment collateral the borrower holds, providing banks with a greater confidence to lend to small businesses. The experience of Michigan's collateral support program – which I know Paul Brown of the Michigan Economic Development Corporation will be discussing today – offers a promising example of the kind of program states could support under the State Small Business Credit Initiative.

The State Small Business Credit Initiative could also support Capital Access Programs (CAPs). CAPs, which are already up and running in about 30 states and cities, offer matching contributions to loan loss reserves when lenders extend credit to qualified small businesses. These reserves serve as a form of insurance on a lender's loan portfolio, with the matching contribution from the state allowing lenders to take on slightly more risk in lending to creditworthy borrowers. Past Treasury evaluations of Capital Access Programs have suggested that they offer a promising means of expanding availability of credit to small businesses, and their track record in states across the country has encouraged members of both the House and the Senate, like Sen. Mark Warner, to promote these programs.

Finally, the State Small Business Credit Initiative would support other efforts like state loan guarantee programs, in keeping with a request made to the President and Secretary Geithner earlier this year in a letter signed by 28 governors across the country – including Governor Martin O'Malley of Maryland, who is represented here today by Christian Johansson of the Maryland Department of Business and Economic Development. This initiative would provide funds immediately to these state programs and would not require states to appropriate matching funds or take other measures that would slow down the urgent need to get funding to small businesses.

We believe these two programs can be established quickly to make credit more available to small businesses so that they can create new jobs. We are eager to work with this Committee and the Congress – including the House and Senate Small Business Committees – to swiftly pass these measures into law as part of a small business jobs package that will support new lending, provide small businesses with tax incentives to grow, and expand the SBA's ability to make credit more available to firms looking to expand and hire new workers.

Thank you for your efforts in working to make credit more available to small businesses across the country. I look forward to taking your questions.

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[1] Here, the smallest loans are defined – using Call Report data – as C&I loans under $1 million, CRE loans under $1 million, and farm loans under $500,000, loans secured by farmland under $500,000, and agricultural production loans under $500,000.

[2] Data are from the FDIC Call Reports. The chart shows the quarterly change in loan balances at an annual rate. Data have been adjusted for mergers and acquisitions. For purposes of this chart, small banks are defined as less than $1 billion in assets, while large banks have greater than $10 billion in assets.