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THE IMPACT OF THE CREDIT CRUNCH ON SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

APRIL 16, 2008

Printed for the use of the Committee on Small Business and Entrepreneurship

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ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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THE IMPACT OF THE CREDIT CRUNCH ON SMALL BUSINESS

WEDNESDAY, APRIL 16, 2008

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
Washington, DC.

The committee met, pursuant to notice, at 2:41 p.m., in room 428–A, Russell Senate Office Building, Hon. John F. Kerry, chairman of the committee, presiding.

Present: Senators Kerry, Cardin, Snowe, and Thune.

OPENING STATEMENT OF THE HONORABLE JOHN F. KERRY, CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MASSACHUSETTS

Chairman KERRY. This hearing of the Small Business Committee will come to order. I apologize for being a little late. We had a vote on the floor. Senator Snowe, the Ranking Member, is introducing a nominee at one of the other committees, but as soon as she is done, she will join us.

I want to thank Governor Mishkin from the Federal Reserve Board and our friend, SBA Administrator Preston, and all of our witnesses for coming here today and taking time to share with us their thoughts about the current situation facing small businesses with the credit crunch.

Needless to say, the effort of this hearing is to really try to focus on—both to learn to what degree from small businesses there is an impact and also to draw attention to what is increasingly in the eyes of the members of the committee a problem that we are facing back home in all of our communities.

Yesterday, I was visiting with the members of the Real Estate Roundtable over here in town, major hotel developers, commercial real estate developers, home builders, others, and we will hear from home builders in our next panel, but the evidence of the credit crunch and its downstream implications is mounting.

Yesterday on the front page of the New York Times, right-hand column, there was a major story about the fallout in retail in America today, and as I talk to people and try to figure it out, it is very, very clear that what began on Wall Street and what was focused in many ways on sort of the bigger picture of the securitization and the portfolios that held subprime loans has really spread way down into Main Street America in very significant ways, and the spillover of this impact just can't be disregarded. It can't be taken lightly.

I am hearing more and more evidence of a broad-spread credit crunch. I think the real estate folks yesterday indicated to me that last year, there was something like $300 billion of deals that were consummated within that entire year. So far this year, in the first quarter, there is a total record of something like $9 billion, perhaps, and that is being generous, and some say if you looked under the nine, you might find it sort of questionable to what degree. Well, obviously if you extrapolate out, you know that is $36 billion versus $300-and-some billion on a year if it holds that way. Nobody can—I can't tell you whether it will or won't.

What I do know is that many people in business are telling me that both the combination of the fear and the inability to gauge risk is causing people to just pull back and has stopped transacting, that people can't necessarily get a price. They can't get a sense of what is in the value and therefore it is very hard to be able to make those deals.

In the most recent survey of banks, the Federal Reserve found that almost one-third of the nation's lenders have tightened their lending standards for small business loans, and today, the National Small Business Association released the results of its annual survey, which showed that 55 percent of small businesses surveyed said they face difficulty in obtaining a loan due to the credit crunch.

The continuing decline in home values has obviously made matters worse. Approximately 30 percent of all small business owners rely on home equity loans in order to finance their small business operations. But as home values decline, many of those small business entrepreneurs have to find an alternative financing source. Some of them will use high-rate credit cards, while others will simply delay or even cancel a planned investment. So that means missed opportunities not only for small business, but for all of the job growth in the ailing economy, which has already shed over 230,000 jobs since January.

Theoretically, the SBA loan program ought to be one of the key players in the effort to fill the gap left by the tightening credit market, but evidence indicates that that may not have occurred this time around. SBA loan activity is down program-wide. Activity in the SBA's 7(a) loan program, the largest single source of long-term capital for small businesses, appears to be in a free fall. The number of 7(a) loans approved by SBA lenders has decreased by about 18 percent compared with the same period last year. In terms of dollars, the 7(a) program is down by over $641 million, which is a decrease of almost ten percent. That sharp decline suggests that, whether temporary or permanent, we may want to consider some changes that might help stimulate that lending and provide more small businesses with financing they need.

Now, in fairness, if you are looking at the inability to measure risk that I just talked about and you are looking at the sort of lack of an end in sight to the devaluation and the spiraling, it is difficult. It is complicated—I am going to acknowledge that up front—to be able to say that you have confidence in putting more money out into something where that person may not have the returns on that investment that, in fact, qualify that loan. So this is a delicate balance and it really mandates both large and small approaches.

Over the past few months, the members of this committee have proposed several measures to try to provide stimulus to lending programs. In January, I introduced the Small Business Stimulus Act of 2008, which was cosponsored by Senators Levin and Landrieu, and that bill would have boosted 7(a) loan activity by reducing the lender and borrower fees charged by the SBA, and that would provide, I think, much-needed support for the micro loan program.

In February, I introduced a modified stimulus bill which added provisions aimed at increasing loan activity in the 504 loan program. I also joined my colleagues, Senators Landrieu and Coleman, in cosponsoring a bill introduced by Ranking Member Snowe which included changes to the tax code that would have benefitted small businesses.

The President's budget for next year reduces SBA funding and raises lender fees to the maximum amount allowed, which may, in fact, be contrary to what we need at this particular moment in time because it could have been used to reduce the newly imposed oversight fees for SBA lenders.

We have a question whether or not the SBA has refused to take appropriate action in responding to the needs of this credit crunch and we would like to explore today sort of what the difference might or might not be between the Fed, which has taken some bolder moves but which obviously may have greater facility in doing so.

We are going to hear the testimony from Governor Mishkin on the Fed's latest actions and how they affect the state of small business in the country, especially the credit markets.

Our second panel of witnesses is going to share with us first-hand accounts of the tightening market for small business loans, and I also hope they will share with the committee the steps they believe ought to be taken to stimulate that activity, because we hope to draft legislation coming out of today's hearings if, in fact, it is warranted and can be effective.

I believe this hearing and the legislation that grows out of the testimony we hear today have the potential to provide some additional kick at levels of our economy where it really needs it, and I look forward to working with Ranking Member Snowe and Administrator Preston to figure out what the best ways are we might be able to do that. Hopefully, we can arrive at a baseline of understanding of what is happening and what might or might not make that difference.

As I mentioned, Ranking Member Snowe will be joining us in a little while, so we are going to go straight to you, Governor Mishkin, and then to you, Administrator Preston, and we appreciate both of you being here. Thank you.

STATEMENT OF HON. FREDERIC S. MISHKIN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. MISHKIN. Chairman Kerry and members of the committee, I am pleased to appear before you on behalf of the Board of Governors of the Federal Reserve System.

Small businesses play a critical role in the U.S. economy and access to credit is essential for their success. My remarks today will address the unusual stress imposed on credit markets in recent months and how that stress appears to be affecting small businesses. So let me turn to small business access to credit in the current financial market turmoil.

As we all know, financial and credit market conditions began to deteriorate rapidly in August. Since that time, credit supply conditions for small businesses have continued to tighten. For example, in the Board's most recent Senior Loan Officer Opinion Survey, conducted in January, a net one-third of the domestic banks surveyed, a larger fraction than the October survey, reported they had tightened their lending standards on commercial loans to small firms over the previous three months. Significant net fractions of banks also indicated that they had tightened price terms on commercial loans to small firms. Actual loan pricing data from our quarterly survey of terms of business lending are broadly consistent with the qualitative data from the Senior Loan Officer Opinion Survey.

Despite tighter credit conditions and loan terms, growth in the dollar amount of commercial loans at U.S. banks was quite well maintained in the first quarter of 2008. Particularly noteworthy from the point of view of small businesses is the fact that after growing almost 20 percent in the first quarter of 2007, commercial loans to small banks continued to expand at a rate of almost 12 percent in this year's first quarter.

Another source of information about small business credit supply conditions is the monthly survey of the National Federation of Independent Businesses. The results of their most recent survey suggest that credit supply conditions for small businesses have held up fairly well over the past several months. For example, over the past few quarters, only about three percent of survey respondents have reported that financing conditions and interest rates were the main business concern.

On a less positive note, in recent months, the net percentage of survey respondents that reported credit was harder to obtain over the previous three months and the net percentage that expected credit conditions to tighten over the next three months have been at the upper end of their ranges observed over the past few years.

Similarly, in the Duke University CFO Magazine Global Business Outlook Survey conducted most recently in March, about one-third of the survey's chief financial officers of small businesses said credit was more costly, less available, or both as a result of the credit market turmoil. This proportion is up slightly from last September.

Looking forward, many small businesses use real estate assets to secure their loans. Continuing declines in the value of their real estate assets clearly have the potential to substantially affect the ability of those small businesses to borrow.

In addition, declines in the value of real estate assets held by banks and other lenders could affect their willingness and ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans. Banks across all size groups, including community banks, have recently experienced a sharp deterioration of credit quality, mostly within loans secured by real estate. Moreover, if banks continue to place on their balance sheets some assets they had expected instead either to place off their balance sheet or to sell to investors, such actions could crowd out loans to some small businesses.

On a more positive note, the vast majority of U.S. banks remain well capitalized. Going forward, this should help these banks to maintain their lending capacity.

So let me conclude. In conclusion, since last fall, credit supply conditions have almost surely tightened for the vast majority of small businesses. On balance, however, credit appears to be generally available, but at a higher cost. Thank you.

[The prepared statement of Mr. Mishkin follows:]

For release on delivery
2:30 p.m. EDT
April 16, 2008

Statement of

Frederic S. Mishkin

Member

Board of Governors of the Federal Reserve System

before the

Committee on Small Business and Entrepreneurship

United States Senate

April 16, 2008

Chairman Kerry, Ranking Member Snowe, and members of the Committee, I am pleased to appear before you on behalf of the Board of Governors of the Federal Reserve System to discuss the availability of credit to small businesses.

Small businesses are critical to the health of the U.S. economy. They employ more than half of private-sector workers, generated well over half of net new jobs annually over the past decade, and create more than half of nonfarm business gross domestic product. Moreover, larger firms often begin as smaller firms that prosper and grow. If small businesses are to continue to provide major benefits to the economy, their access to credit is clearly a high priority. My testimony today will address the unusual stress imposed on credit markets in recent months and how that stress appears to be affecting small businesses.

Small Business Access to Credit and the Current Financial Market Turmoil

As we all know, financial market conditions began to deteriorate quite rapidly in the middle of last August. In response to these and subsequent events, and in recognition that growth of the U.S. economy was slowing, the Federal Reserve has, since last fall, taken a number of strong actions aimed at both restoring the normal functioning of financial markets and at stimulating the real economy.

Although our actions appear to have helped stabilize the situation, financial markets remain under considerable stress. For example, many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and have increased the amount of collateral they require to back short-term security financing agreements. Credit availability has also been restricted because some large financial institutions, including some large commercial and investment banks, have reported substantial losses and asset write-downs, which reduced their available capital. The capacity and willingness of some large banks and other financial institutions to extend new credit has also been limited by the reduced availability of external funding from the capital markets for originated assets. The resulting unplanned increases in their balance sheets have strained their capital, thus reducing lending capacity. The good news is that several of these firms have been able to raise new capital, and others are in the process of doing so. However, market stresses are likely to continue to weigh on lending activity in the near future.

With this general background in mind, let me now address how the financial market turmoil of the past several months appears to have affected access to credit by small businesses. As you may recall, in my testimony before the House Committee on Small Business in November, I concluded that while credit conditions had no doubt tightened since mid-August, small businesses generally seemed to have been able to retain access to credit.[1] However, I emphasized that the uncertainty surrounding that conclusion was unusually high, and it was far too early to draw any firm conclusions. To some extent that is still the case, although we clearly have more information to work with now in assessing the effects of financial market turmoil on small business access to credit.

In its initial stages, the current financial market turmoil and associated problems in the housing market were focused on markets for securitized assets and affected primarily large financial organizations. In large part because only a small share of small business loans are securitized and because it is the relatively smaller banks that tend to specialize in providing "relationship finance" to small businesses, credit supply to small businesses held up rather well.

[1] Frederic S. Mishkin (2007), "Availability of Credit to Small Businesses," statement before the Committee on Small Business, U.S. House of Representatives, November 7, www.federalreserve.gov/newsevents/testimony/mishkin20071107a.htm.

Still, even in November it was clear that credit conditions had begun to tighten for small businesses.

The trend toward tighter credit supply conditions for small businesses has continued since last fall. For example, in the Board's most recent Senior Loan Officer Opinion Survey, conducted in January, a net one-third of the domestic banks surveyed--a larger net fraction than in the October survey--reported that they had tightened their lending standards on commercial loans to small firms over the previous three months.[2] Significant net fractions of banks also indicated that they had tightened price terms on commercial loans to both small and large firms. The net fractions of banks reporting tighter lending standards and pricing terms on commercial loans in the January survey were relatively high by historical standards going back to 1990.

Actual loan pricing data from our quarterly Survey of Terms of Business Lending are broadly consistent with the qualitative data from the Senior Loan Officer Opinion Survey. For example, data from our most recent survey, taken in February, indicate that the average interest rate on commercial loans relative to the bank's cost of funds (the bank's spread) rose modestly from the corresponding survey week of three months earlier. Of particular importance for small businesses, however, are the facts that these spreads jumped significantly both on loans originated by smaller U.S. banks and on smaller commercial loans--that is, those loans below $100,000.

Despite tighter credit standards and loan terms, growth in the dollar amount of commercial loans at U.S. banks was quite well maintained in the first quarter of 2008. Particularly noteworthy from the point of view of small businesses is the fact that after growing

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[2] Board of Governors of the Federal Reserve System (2008), "The January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices" (January), www.federalreserve.gov/boarddocs/SnLoanSurvey/200801. In October, a net 10 percent of banks reported tightening lending standards to smaller firms. The net percent of banks is defined as the percent tightening less the percent easing standards.

almost 20 percent in the fourth quarter of 2007, commercial loans at small banks continued to expand at a rate of almost 12 percent in this year's first quarter.[3] Thus, although slowing somewhat, commercial loan growth has held up in recent months even though banks' terms have tightened and economic growth has slowed, the latter driving down the demand for small business and other commercial loans. On balance, this suggests that credit is generally available, albeit at a higher cost.

Another source of information about small business credit supply conditions is the monthly survey of the National Federation of Independent Businesses (NFIB). The results of the most recent NFIB survey, conducted in March, suggest that credit supply conditions for small businesses have held up fairly well over the past several months. For example, over the past few quarters only about 3 percent of survey respondents have reported that financing conditions and interest rates were their main business concern, and for March that number was only 2 percent.[4] In addition, according to the NFIB survey, the average short-term interest rate paid by borrowers has remained at the low end of its historical range. On a less positive note, in recent months the net percentage of NFIB survey respondents that reported credit was harder to obtain over the previous three months and the net percentage that expected credit conditions to tighten over the next three months have been at the upper end of their ranges observed over the past few years. Still, these percentages have remained well below their highs reached in the early 1990s and are below their levels from last September's survey when they temporarily spiked up.

On the demand side, the NFIB survey's results are quite pessimistic. For example, the survey's index of small business optimism has dropped to its lowest level since the monthly

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[3] The first quarter's numbers have been adjusted for some statistical anomalies in February.

[4] These levels are far below their peaks of the early 1980s, when more than one-third of respondents reported that financing conditions were their main concern.

surveys began in 1986, as the net percentage of borrowers that believe it is a good time to expand their business has fallen to the bottom of its range over the past two decades. This contrasts sharply with survey responses last September which indicated that the NFIB's index of small business optimism and the fraction of firms that considered the next three months "a good time to expand" had remained at levels similar to those seen in the first half of 2007. If demand conditions continue to deteriorate, reduced demand for loans could lead to future declines in small business loans even if credit supply conditions remain about the same.

A less comforting picture of small business credit supply conditions is provided by the Duke University/CFO Magazine Global Business Outlook survey, conducted most recently in March. About one-third of the chief financial officers (CFOs) of small businesses who responded said credit was more costly, less available, or both as a result of the credit market turmoil. This proportion is up slightly from last September, when that sentiment was reported by about one-fourth of responding small business CFOs. This survey also asks respondents to rank their top three concerns, with the (changing) options given in the survey. "Credit markets/interest rates" was ranked as the second top concern among small business CFOs in both the March 2008 and the September 2007 surveys.[5]

Perhaps one of the most important concerns about the future prospects for small business access to credit is that many small businesses use real estate assets to secure their loans. For example, data from our 2003 Survey of Small Business Finances (SSBF) indicate that 45 percent of the total dollar amount of small business loans outstanding in 2003 was collateralized by some

[5] The top concern in March was customer demand, whereas the top concern in September was the cost of labor.

type of real estate asset.[6] About 37 percent was collateralized by business real estate assets, and 15 percent was secured with "personal" real estate.[7] Looking forward, continuing declines in the value of their real estate assets clearly have the potential to substantially affect the ability of those small businesses to borrow. Indeed, anecdotal stories to this effect have already appeared in the press.

Similarly, declines in the value of real estate assets held by banks and other lenders could affect their willingness and ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans. Indeed, there are reasons to believe that these forces are currently at work not only at large banks, where the initial problems were observed, but across the full size spectrum of banking organizations. As noted previously, more stringent loan terms are already in place. In addition, banks across all size groups, including community banks, have recently experienced a sharp deterioration in credit quality, mostly within loans secured by real estate. Moreover, if banks continue to place on their balance sheets some assets that they had expected instead to place in conduits or otherwise sell to investors, the move could crowd out loans to small businesses and other borrowers.

On a more positive note, the vast majority of U.S. banks remain well capitalized. Going forward, this should help these banks to maintain their lending capacity. In addition, lender constraints on small business loans may be mitigated somewhat by loan guarantees provided by the Small Business Administration (SBA).

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[6] Board of Governors of the Federal Reserve System (2003), "2003 Survey of Small Business Finances," www.federalreserve.gov/pubs/oss/oss3/ssbf03/ssbf03home.html; *Traci L. Mach* and *John D. Wolken* (2006), "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin*, vol. 92 (October), pp. A167-A195, www.federalreserve.gov/pubs/bulletin.

[7] The two components sum to more than 45 percent because some loans are collateralized by both business and personal real estate.

The interdependencies between small business and household finance are among the most interesting and least understood aspects of small business access to credit. In addition to personal real estate assets, other household assets such as automobiles may be used as collateral for small business loans, and personal credit cards and savings accounts are sometimes used to help finance a small business. For example, our SSBF documents that, in 2003, almost 47 percent of small businesses used personal credit cards in the conduct of their business. At that time, most of this use appeared to have been for convenience rather than for longer-term borrowing. However, to the extent that small businesses become more reliant on credit cards as a source of funding, perhaps because of a decline in their own financial condition or because of a tightening in other aspects of credit supply, they may end up facing higher interest rates than would otherwise be the case.

Conclusion

In conclusion, the health of the U.S. economy depends importantly on the vitality of the small business sector, and continued access to credit on competitive terms is necessary for that vitality. On balance, since last fall credit supply conditions have almost surely tightened for the vast majority of small businesses. Credit appears to be generally available, but at a higher cost. Only a small fraction of small business owners report that credit is their main business concern. Demand for their products is much more problematic.

Looking forward, continuing declines in the value of small businesses' real estate assets have the potential to substantially affect the ability of those small businesses to borrow. Similarly, declines in the value of real estate may affect the ability and willingness of banks and other lenders to supply loans. Indeed, this is likely already occurring to some extent at some banks across the full spectrum of bank sizes. Lastly, because of interdependencies between small business and household finance, declines in the financial condition of households can also affect both the terms of those households' small businesses loans and their ability to borrow.

For all of these reasons, the Federal Reserve will continue to monitor closely the effects of financial market conditions on small business access to credit. More generally, I assure you that the good health of the small business sector is an important consideration for the Federal Reserve as we strive to fulfill the dual mandate given to us by the Congress to promote both price stability and sustainable economic growth.

Chairman KERRY. Thank you very much, Governor.
Mr. Administrator.

STATEMENT OF HON. STEVEN C. PRESTON, ADMINISTRATOR, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. PRESTON. Thank you, Chairman Kerry. Thank you also, Governor Mishkin, for coming. I also just want to thank the members of the second panel. You have put together a good group of people who do a lot of good work for small businesses.

I think as we look at this situation right now, clearly over the past several years we have seen a very strong period of economic growth, a period of low unemployment, and a period of very good broad economic conditions. Most recently, however, in the fourth quarter, we saw GDP growth fall to 0.6 percent, and if you are a small business owner, we are looking at higher prices at the pump, higher prices in the supermarket, and home prices are down. Those are all factors which clearly affect the cost of running a small business and the markets for many of their products.

In June, the President signed the bipartisan economic growth package which will inject $152 billion into the economy. The package will support not only consumer and business spending, but it is also going to provide important tax incentives for businesses to make investments in new equipment this year with the depreciation and expensing benefits. We hope that the boost from the stimulus package will help buoy the economy in the coming months, but also very importantly give small businesses an incentive to invest back in their business because of those cash benefits.

Confidence in the economy is particularly important for small businesses. In deciding whether to invest in expanding a business, which may require taking on new debt, it is very important that business owners have that confidence in the economy and that the customers will be there to justify those investments.

I think a lot of us have seen a number of surveys out there by NFIB and NSBA and the Chamber. All of those indicate that confidence among small businesses has declined in recent months, and I think it also shows that general concern about the economy has increased.

In addition, what I think is real important for our group, is it shows that small businesses' intention to hire and intention to invest back in expansion of their business has also declined. Those are very much the kinds of decisions which drive the need for capital which our programs support. That is very consistent with what we have heard from our lenders and our borrowers.

We have had hundreds of outreach meetings with lenders to discuss what is going on in the marketplace. Many of the lenders have indicated they have seen this uncertainty and it has resulted in less demand for credit in the small business community. Many lenders have actually indicated that they are having some challenges putting good capital to work right now in the marketplace. That is also supported by the Fed January 2008 Senior Loan Officer Opinion Survey, which shows one-fourth of both large and small domestic banks saw weaker demand from small firms. However, demand is not the only factor, but it is an important one.

The survey also found that some domestic institutions have tightened their standards, as Governor Mishkin said. That is consistent with what Secretary Paulson stated when he commented recently that he believes the sentiment has swung to risk aversion. It is also consistent with my own conversations with lenders.

Many of our lenders have experienced a significant increase in credit losses in their portfolios and they have responded by tightening credit standards. We see a reflection of this in our own portfolio. Clearly, the greatest declines that we are seeing in our portfolio are in areas where we see the greatest risk.

In addition, small businesses who are facing challenges due to the economy or who have less collateral because their home values have declined, no longer are able to meet the same credit standards that they were before. So they don't look as good on paper as they might have a year ago when a bank is considering a credit decision.

That flow of capital between banks and small businesses is obviously critical for growth. We have been working very diligently with lenders to ensure that capital is available to those small business owners who want it and need it. We have held roundtables in cities around the country, major lending centers, smaller communities, as well. We have held very in-depth relationship review meetings around the country in our field. We have had—in just the last month, we have had over 800 meetings in our field to sit down with lenders to talk about their strategies, to talk to them about the quality of their portfolios, to encourage them to expand the use of SBA product where it is appropriate, and to make sure we understand if there is anything that we need to do to support them to expand the use of our program. Those sessions have given us a great opportunity to both articulate the value of our guaranteed lending and also to discuss the issues that they have that are of concern to them.

Beyond that, I would like to emphasize that we conducted very extensive lender outreach in late 2006 and early 2007 to make sure we understood before any of this happened how to expand our presence in the lending community. We are addressing many of the issues we heard from lenders where they told us—when they explained to us what was inhibiting their participation in our programs back then, and we have gotten great feedback on the progress we have made.

We are purchasing their loans much more quickly. We had some terrible backlogs in our guaranteed purchasing operations. We are turning those very quickly. We are providing much better on-site bank support for our field network. We have simplified our policies. We have just rolled out a whole new set of policies last month. We are moving away from paper to electronic transactions and we are rolling out new programs, like Patriot Express and Rural Lender Advantage.

Much of the industry, especially the small banks, were very disappointed when Low-Doc was discontinued. We lost over 400 active lenders from 2005 to 2006, most of them small lenders. Since then, we have piloted something called Rural Lender Advantage to bring back those lenders into the programs. Based on the pilot, we are making some adjustments to simplify that program based on the industry feedback. But effectively, it provides lenders with a simplified application. It is electronic. We turn around the decisions very quickly. We provide them with a lot of customer support. We give them the same guarantee structure as the old Low-Doc. We actually increased the maximum from 150 to 350 thousand, but it allows us to ensure that we have got consistent underwriting standards so that the program is more viable than the Low-Doc program was.

So, like you say, SBA is working very hard on a number of fronts to support the lending community in a very hands-on way, but in a more structural way, as well. Certainly we stand ready to handle an increase in volume, whatever this committee and Congress and the President decide to do. We certainly would look forward to that, and I would also like just to thank you for the opportunity to share our thoughts on this important topic.

[The prepared statement of Mr. Preston follows:]

TESTIMONY OF

ADMINISTRATOR STEVEN PRESTON

United States Senate

Small Business and Entrepreneurship Committee

Wednesday, April 16, 2008

Chairman Kerry, Ranking Member Snowe, distinguished members of the Committee, thank you for inviting me here today to discuss the current state of our economy and the impact it is having on small businesses.

After 52 consecutive months (over 4 years) of job growth, our economy and our financial markets are going through a difficult time.

While the current state of our economy is under pressure, I continue to be optimistic that the ingenuity and resolve of American small business will help put our economy back on track.

Economic data shows that unemployment is still low at 5.1 percent and productivity remains strong. Exports are at an all-time high and growing, and for 2007 the federal deficit was 1.2 percent of the Gross Domestic Product which was well below the 40 year average of 2.4 percent of GDP.

However, real GDP growth fell to 0.6 percent in the fourth quarter of last year. Prices are up at the gas pump and in the supermarket, and home prices have declined.

These factors are clearly affecting the cost of running a small business and the markets for many of their products. In February, President Bush signed the bipartisan economic growth package which will inject over $152 billion into the economy. This package will support both consumer and business spending. The rebates that will begin distribution in May will support consumer spending, support job creation, and boost economic growth. The package also includes tax incentives for businesses to make investments in new equipment this year -- a 50 percent bonus deduction on new equipment that normally would be depreciated over a longer term, and an increase in the limit on expenses that small businesses can deduct from annual income. The boost from this stimulus will help buoy the economy in the coming months and strengthen consumer confidence.

Confidence in the economy is particularly important for small businesses. In deciding whether to invest in expanding their businesses, which may require taking on new debt, business owners want to be confident that the economy will be strong and customers will continue spending. We have seen some evidence that confidence among small businesses has declined in recent months and general concern about the state of the economy has increased. SBA has held numerous lender outreach meetings to discuss the situation with our lending partners. Many of these lenders have indicated that this uncertainty has resulted in a diminished demand for credit in the small business community. However, these lenders have not indicated a shortage of credit available for borrowers.

This is supported by the Federal Reserve Board's January 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices, which shows one-fourth of both large and small domestic banks saw weaker demand for loans from small firms. Most domestic institutions that indicated a weakening of loan demand pointed to a decrease in customers' needs to finance inventories and investment in plant and equipment.

The survey also found that some domestic institutions have tightened their standards on commercial and industrial loans. This is consistent with Treasury Secretary Paulson's statement that sentiment has swung to risk aversion. While many lenders have experienced an increase in credit losses in the portfolio, they have responded by tightening their credit standards. We believe this will widen the pool of individuals who can be helped by SBA loans, and we are following up with new outreach and education efforts to reach these businesses. In addition, SBA is ready and available to help business owners who can no longer rely on their home equity lines of credit to finance business expansions.

As a reflection on the general economy SBA has seen a decline in its loan-guarantee volume both because of a lower demand for capital and because of a tightening of credit standards. Lenders generally have a strong desire to use the SBA guarantee to lessen their risk. We believe our programs will be a critical source of capital for small businesses in this environment.

The flow of capital between banks and small business borrowers is critical for economic growth. As I stated before, the Administration has been working diligently with lenders to ensure that much needed capital is available to small business owners. SBA has held roundtables around the country in cities including Boston, New York, Denver, Atlanta, San Francisco, Los Angeles, Philadelphia, and Washington as well as individual meetings around the country with hundreds of lenders in recent months to review their strategies and the quality of their portfolios, and to support their use of SBA products to reach small businesses. These sessions have given SBA the opportunity to both articulate the value of SBA's guarantee to lenders and discuss with lenders issues of concern to them.

SBA believes that our efforts in outreach are paying off. We have seen a 4 percent increase in new lenders using our programs. As these new avenues of lending open, we believe our programs will help lead to further economic growth.

You can be confident that the SBA is prepared to handle any increase in demand if lenders decide to rely more heavily on the government guaranteed lending products. Furthermore, SBA remains dedicated to its mission of providing capital to underserved markets and will continue to urge lenders to support this important segment of the market.

Thank you for the opportunity to share with you what SBA is doing to help borrowers face this current uncertainty and I look forward to answering any questions you many have.

Chairman KERRY. Well, thank you very much, Administrator.

Let me see if we can sort of flesh out a few of these things here, if possible. Mr. Mishkin, what in your judgment—obviously, the Fed has moved in a lot of different ways. Some people have suggested the Fed may have already exhausted the remedies available to us. Do you think that is accurate?

Mr. MISHKIN. I think that that is not quite correct. Clearly, the nature of the shock to the financial system is actually very major and there are aspects of this that, in fact, are out of our control, in particular the fact that people are having trouble valuing assets. The credit risk has gone up to a major extent.

However, monetary policy is effective in dealing with these——

Chairman KERRY. Can I just stop you there for one quick second before we go on. I want to get back to the rest, but——

Mr. MISHKIN. Sure.

Chairman KERRY [continuing]. How do you get, then, to this point? Do you just have to wait until the market settles that you are suddenly able to measure this risk, or are there steps that could be taken that could help to eliminate this imponderable, this fear factor and get people to being able to value things more effectively?

Mr. MISHKIN. I think that there is part of the risk that we can't do anything about. In fact, the way I have thought about this is there are two elements of this risk. One is what I call valuation risk—the fact that you have to figure out the value of these underlying assets—and that can be very difficult to do. But there is also an element of macroeconomic risk, which is that there is a feedback between what happens in terms of the overall economy and the credit markets. So if people are very concerned that the economy will get into real trouble, that means that they are actually going to say there is more risk and, in fact, it is even more difficult for them to value assets.

Chairman KERRY. Right.

Mr. MISHKIN. So part of our job at the Federal Reserve is, in fact, to reduce this macroeconomic risk, and there are two elements of this. One is monetary policy, which we have aggressively eased from what was going on before August, and, improvement in the functioning of financial markets, particularly in terms of liquidity facilities. And both of those have been important steps in this direction.

Chairman KERRY. But there are some limits, I assume, as to how far the Fed can go on the monetary piece.

Mr. MISHKIN. Well, clearly, you can't get interest rates below zero, so, in fact, we call that the zero lower bound on interest rates. But we actually have interest rates at two-and-a-quarter percent and clearly there is some room to lower them if it is needed.

Furthermore, we are continually looking at steps to make the markets function better and I think we have been quite creative in the steps that we have taken so far. But, in fact, we will continue to look at everything that can take to getting the financial markets back to a more normal situation.

Chairman KERRY. Do you see specific steps which either the Fed or the FDIC or the Congress could take at this point that would more rapidly get capital into—that would begin to allow that capital to move more rapidly into people's hands and ease the crunch?

Mr. MISHKIN. Well, there clearly are issues that the Congress is looking at—such as whether they can make, the housing market work better—which we encourage you to do and would clearly have an impact on credit markets.

Chairman KERRY. In your testimony you talked about a tightening of credit standards, higher rates, higher costs for credit, and the decline in the use of real estate assets as collateral in order to do that. So you have got these three elements. Is there one that is more important than another as to most affecting the access of a small business to credit?

Mr. MISHKIN. Well, it is hard to say which of these is more important. I think the most important issue affecting small businesses is what will happen to the overall economy and the availability of credit. In fact, there has been more difficulty in their access to credit, but the situation is not dire. Credit is still being issued and small businesses are able to get access to credit.

What I think is a bigger concern for small businesses is whether, in fact, they are going to have demand for their products. So in that sense, a key issue for the Federal Reserve and a key role in terms of helping us to promote small business is to make sure that the economy stays on an even keel.

Chairman KERRY. So in thinking about responses to this, how do you deal with the sort of sense that at one moment, we are cruising along. People are borrowing. People are investing. Small businesses have their contracts, their sales. The outlook is relatively decent. And then you have this uncertainty in one particular part of the market, the subprime, the real estate, where a bunch of folks aren't too sure what is in their portfolios, what the values are and so forth, and you sort of pull the rug out from under all these other assumptions that are being made.

To what degree are we now trapped in a self-fulfilling prophecy syndrome, where because people are looking out there, the interest rates what they are still, and the market has a bubble, then everybody says, well, I can't tell. Therefore, I am not borrowing, or I am not lending, and you just cascade downwards.

Mr. MISHKIN. Well, clearly, one of the things that happened is this disruption—in terms of the subprime market—has actually spread much wider and——

Chairman KERRY. Why has it? A lot of people don't understand that.

Mr. MISHKIN. I think the reason it has spread wider is because it actually revealed that the securitization model, which is a key part of providing funds to the capital markets nowadays, actually is flawed. And the subprime lending was frequently driven by the fees that the originators were getting, and not worrying about whether, in fact, the ultimate holder of the loan would get that back——

Chairman KERRY. Subprime is a nice word, term of art, for describing loans that shouldn't have been made.

Mr. MISHKIN. I think I would differ with you on this in the following sense——

Chairman KERRY. Wasn't the whole concept of subprime that people get credit where they wouldn't otherwise qualify for the credit?

Mr. MISHKIN. I think that the issue is that there clearly is a lot of subprime lending that should not have been done, and in that sense, I agree with you completely. There is an issue about the quality of information in the marketplace, basically through technology, which actually may allow people who previously were not able to get credit to get credit if it is actually underwritten to them properly, so——

Chairman KERRY. Let us flesh that out a little bit.

Mr. MISHKIN. So in this episode, the problem is not so much that all of the subprime borrowers were bad borrowers. But many of the lenders actually lent to people who, in fact, should never have gotten the loans. As I said, some of the reasons this happened was because the incentives of the originators of these loans were not always in the interest of either the person who eventually held the loan or even in the interest of the borrowers.

The problem then is that then revealed there are similar kinds of problems elsewhere in the capital markets in terms of securitization, where people were assuming that the credit rating agencies were going to get it right and weren't doing due diligence on their own. It then actually spread much wider, creating some problems in terms of bank capital, because banks, in fact, owned portfolios of these assets and had losses as a result. This ate into some of their capital. So that have actually resulted in some of the credit restrictions that you talked about at the very outset, which, in fact, has created a problem not only for the real estate sector, but actually for the small business sector, as well.

Chairman KERRY. And do you agree that the small business sector winds up getting caught up in that psychology——

Mr. MISHKIN. Absolutely. I think that, first of all, small businesses are a key element of the strength of the economy in this country. I actually come from a small business background. I worked for several years in my father's small factory in Manhattan; they used to have them there. And we know that a lot of the growth in the U.S. economy and a lot of the very rapid growth in entrepreneurial activity has actually occurred in small businesses.

So clearly, what started in one part of the economy, which had really very little to do with small businesses, has ended up creating problems for small businesses for the economy as a whole. Clearly, one of the key missions for the Federal Reserve is to try to keep the macroeconomic risk in the economy reduced so that, in fact, we can have recovery of activities for small businesses and for businesses in general.

Chairman KERRY. But a significant part of that recovery, by your earlier testimony and by what we have discussed here, is the inability to be able to actually value, correct?

Mr. MISHKIN. Absolutely.

Chairman KERRY. Is there a way for the Fed or even the SBA to create some protocol that begins to establish how one does value at this point or to create value at this point?

Mr. MISHKIN. I think——

Chairman KERRY. The Fed has more ability to create the value.

Mr. MISHKIN. Right. I think that what much of this in terms of valuation has to be done by the markets. What the Federal Reserve can do is—by restoring confidence in what will happen to the economy in the future—help make it easier for the markets to do their job. But the reality is that the financial markets have to figure out what the value of assets are, where the losses are, and the Federal Reserve——

Chairman KERRY. Are they being too cautious in doing that? Is there a way to break the cycle?

Mr. MISHKIN. I don't know if the right word would be cautious, but clearly it is a very difficult issue for them to sort out. Clearly, having more transparency in the system would be helpful to them in doing this. So there are issues in terms of whether the financial systems can be made to work better in this regard.

Chairman KERRY. As you know, the next loan officers' survey from the Fed is going to come out next month. Based on what you have seen thus far, do you anticipate that the trend towards tighter lending standards is going to be sustained?

Mr. MISHKIN. Well, unfortunately, I don't have any information yet about what is going on in that survey, so I really can't comment on what——

Chairman KERRY. Do you have any anecdotal or——

Mr. MISHKIN. I think the only anecdotal information we have been hearing in some of these other surveys is that small businesses are facing more uncertainty in terms of their ability to get credit.

Chairman KERRY. So what do you do about the frustration of a small business person who has got contracts, product, workers, but they can't get the working capital to continue to do what they know they can do?

Mr. MISHKIN. Well, unfortunately, we can't directly help small businesses, but, in fact, if we fulfill our mission of both maintaining price stability and sustainable employment, then it can happen. So it is indirect, but I still think important.

Chairman KERRY. What indicators are you going to be looking for to get a sense of whether or not you should take stronger steps in terms of—I mean, small businesses are 98 percent of our businesses. They are obviously going to be impacted by macro forces over which they have no control. What are you going to be looking for here?

Mr. MISHKIN. Well, we actually look at a whole range of information to make assessments about what is going on in the economy, including, by the way, talking to small businesses. The Federal Reserve Banks have committees where they meet with small businesses. When I was at the Federal Reserve Bank in New York about ten years ago, we had periodic meetings with an advisory committee from the small business and agricultural sector, and that was very helpful to us in providing information about those sectors.

Of course we look at the national statistics. We very much look at what is going on in credit markets so that we are not just looking at where the real economy is now, but at information in financial markets which may tell us something about where the economy may be heading in the future. So we do use a lot of science, but there is also a lot of art to monetary policy and we actually use both very extensively.

Chairman KERRY. What would your message be to small business owners listening today as to what they might look to as potential options that could change the view for them?

Mr. MISHKIN. Well, I think that they have to, first of all, most importantly, look to their own markets, and in looking to their own markets make an assessment so that they have a good feel for what will happen. One of the strengths in the economy in recent months has been the export sector. And, in fact, small businesses do a lot of exporting. So looking for new markets is something that they can also do to improve their profitability and their ability to invest.

Chairman KERRY. You have seen both the stimulus package and the housing package that have been, one passed and the other being worked on here. Are there steps, other steps that might be more constructive by the Congress than those you have seen?

Mr. MISHKIN. Well, I think at this stage, it is, I think, worthwhile to see exactly how well the packages that have been passed work. The stimulus package is not going to kick in for a couple of months. We are hopeful that it will help the economy get through this period of slow growth. And I think when we see what happens there, then we will have a little bit better idea what we might need to do in the future.

Chairman KERRY. Administrator Preston, I will just ask you a question and then I will turn to Senator Cardin and then come back, but there is a chart over here that indicates the—and maybe we can get the chart up—that indicates the decrease in the number of 7(a) loans approved by the lenders, about 18 percent down from the same period last year. I mentioned that represents about $641 million. Do you have any judgment to offer the committee about whether or not the fees have been a factor in that downward trend?

Mr. PRESTON. I certainly don't think it is the primary factor or even an overwhelming factor. What we have consistently heard——

Chairman KERRY. But a factor?

Mr. PRESTON. I think on the margin, any additional fee has an effect. But what we have consistently heard from the lenders is either demand is down or we stretched too far and we have had a pull-back. And when we look at where our loans have declined, it is almost all smaller unsecured lines of credit, mostly through sort of credit-scored products. And if we look at the lenders where the decline happened, about 70 percent of the decline came from three lenders that have pulled back very dramatically, in the number of loans. The dollar value, decline is a little bit less dramatic than that, but it is also heavily concentrated.

So, you know, the other thing we are hearing, and I know we are talking about kind of broader macro issues to an extent, but what we have seen very clearly is it is not a one-size-fits-all behavioral adjustment on the part of banks. Many of them had different practices in using our programs. Many of them were a lot more aggressive than others. A lot of lenders are saying they haven't changed their credit standards one bit and they are pushing hard to find good value. Others have said, we got so far ahead of ourselves, and we are pulling back dramatically and figuring out what we need to do.

So I think it is important to understand where it is pocketed and where it is not, and we do see, continued, I wouldn't say strength, but a much lesser decline in larger loans, certainly any loans that have collateral in them, among most institutions since a handful are driving the decline.

Chairman KERRY. Senator Cardin, are you ready to go? I will come back afterwards if you are set to go.

Senator CARDIN. Thank you, Mr. Chairman.

Chairman KERRY. Do you want to press your button there?

Mr. PRESTON. I had that same problem a minute ago.

Senator CARDIN. Thank you for turning me on, Mr. Chairman. I appreciate it.

Chairman KERRY. It is my job.

[Laughter.]

Senator CARDIN. Let me first thank our witnesses. To Administrator Preston, my staff has shared with me the letter that you sent back to me in response to the question from the prior hearing dealing with minority participation in our loan programs. I haven't had a chance to absorb all of this, but clearly, it looks like the trend lines are favorable and I thank you for supplying the specific information for the country and for Maryland. I look forward with you in making sure that opportunities are provided, particularly to minority businesses in this country, in the most effective way, and I thank you for that response.

I just want to follow up on the Chairman's point, if I might just for a moment. One of my concerns is that small business owners, the statistics sometimes don't really reflect what is happening there. We see the statistics, but business owners are proud people and they are in real trouble today and they are trying to figure out a way to stay afloat. When there is a credit crunch, they still need credit, and in many cases, they go to much more expensive credit sources. They use their credit cards and pay a much higher rate, which is only going to cause a greater difficulty for them being able to keep their business afloat.

So I am just interested as to whether you are seeing trends with small businesses today where they are substituting some of this credit for more expensive credit, which could really affect their ability to stay in business.

Mr. PRESTON. Yes. I think that is a great question and it actually dovetails well with another question that I wanted to comment on that Senator Kerry had asked. I think we kind of lump small business into one big chunk, but I think the surveys are kind of showing us that the somewhat larger small businesses that have a little bit more balance to them continue to have good relationships with banks. Their markets are impacted, their sales are impacted economically, but the credit as I see it and from what I have read, and as I have listened to people, that doesn't seem to be as much where the squeeze is.

When you go further down to the smaller small businesses, that is where you see a lot more people financing off of credit cards, a lot more off of home equity lines. A lot more people, if they are going to go to the bank they need that home equity as a source of collateral for a bank loan. And my concern is it is more at that end of this spectrum that we are beginning to see some more of the challenges. And to the extent that bank credit is not available for those people, you would expect them to go to credit cards. I don't have any empirical evidence to tell you that it is happening, but we see the logic behind that.

And so if you match that with my earlier point that not all banks are behaving the same way, that is why it has been so important for us to get out there and meet with hundreds of banks to say, let us look at what is happening in your portfolio. Let us look very individually, bank by bank, how you are lending to small businesses, how you use our programs, and how you can expand your capital to small business by working more closely with us, because they all use our programs differently, too.

You know, just like lending is one business at a time, our relationship with those banks is similar. So we are really trying to get out there and work that issue, but I think your concern is very real. And I know you are going to be talking to some people from the building industry afterwards. We are seeing the impact in our portfolio much more heavily in construction and in hospitality and a few industries that seem to be getting harder hit.

Senator CARDIN. I know that Chairman Kerry has legislation that he is advancing that will try to make the tools more readily available to small businesses during these economic problems. I would just urge us all to really think beyond maybe traditional thinking here, because I really do think the economic conditions here are different than we have seen in past recessions. We know that we rely upon small business for economic growth. I am just worried that we might be missing the problems that small businesses are currently facing and I think the Chairman's approach is an excellent approach to try to provide greater help from the SBA and from the Federal sources removing some of the perhaps obstacles for small businesses taking advantage of these tools.

But I would just urge you to try to get as much information as possible about what is happening out there and whether small businesses are using alternative sources for credit that really could be causing a serious problem for their future stability and growth and making it more difficult for us to come out of this economic downturn.

Thank you, Mr. Chairman.

Chairman KERRY. Thank you very much, Senator Cardin. I appreciate that.

We have been joined by the Ranking Member. Senator Thune, if you don't mind, I am going to turn to her, or you guys fight it out. It is your side. [Laughter.]

Senator SNOWE. We never fight on our side. [Laughter.]

OPENING STATEMENT OF HON. JOHN THUNE, A UNITED STATES SENATOR FROM SOUTH DKAOTA

Senator THUNE. Thank you, Mr. Chairman and Senator Snowe. Thank you for holding the hearing, and I want to thank our panelists for coming today, as well.

This is a critically important issue and I think my State is probably no exception. When you look at the impact of small businesses on the economy across the country and where the jobs are created, you see they are created in small businesses. So making sure that we have got a good strong small business sector of our economy with the availability of capital and liquidity is really critical. So examining this issue in greater detail and identifying what some of the problems and issues are and then trying to fashion some solution to those, I think this too is extremely important. So I want to thank you for holding the hearing and I want to thank you for sharing your insights. I know we are going to hear from a panel of business owners and people who are directly impacted by the credit crisis in a little bit.

Dr. Mishkin, have you noticed any trends as to what areas of the country or what business sectors are most affected by the credit crunch?

Mr. MISHKIN. Well, clearly the sector of the economy that has been most affected is the housing sector. We have seen a very, very dramatic stop in housing starts. There is still a lot of inventory of houses on the market, which is a drag on that sector.

Chairman KERRY. Is your mike on?

Mr. MISHKIN. Yes, it is lit.

Chairman KERRY. Pull it a little closer. Thank you.

Mr. MISHKIN. So clearly, this sector has really been quite an important drag on the economy. Last year, it basically lowered economic growth by about one percentage point. So that is really the sector that has been most heavily impacted by what has happened.

But clearly, there are other sectors of the economy that have also weakened. Household spending has been quite weak in the last couple of months, and so there have been spillovers elsewhere, as well.

Senator THUNE. How about areas geographically?

Mr. MISHKIN. Well, geographically, we concluded there are big differences in different parts of the country. So if you are, for example, growing corn, you are doing quite well right now, so many of the agricultural States are doing quite well. If you are pumping oil, you are also doing quite well. But on the other hand, if you are manufacturing goods and you can't sell as many of them, that is a real problem for you.

So there are certain parts of the country, clearly, that have suffered more than others. The Midwest clearly has some serious problems, besides the fact that their weather is not so great. But in general, in any kind of a situation where there has been a slowing of growth, some parts of the country get hit worse than other parts of the country. Small businesses actually have to look to their local market as well as the national market.

Senator THUNE. I think one of the concerns with the mortgage crisis as it relates to small businesses is that home values have decreased and many small businesses rely on home equity for credit. Can you explain how this affects the small business credit crunch and does that problem spill over into other areas of the country which are not being as directly affected by the mortgage crisis, at least not presently?

Mr. MISHKIN. Yes. The issue of what happens in the real estate sector is very important to small businesses because frequently the collateral that they use to back up the loans and therefore get lower interest rates is, in fact, tied up to real estate. And if the value of that goes down, either the lender is not as sure that they will pay them back and therefore will actually charge them a higher rate, or they will have access to less credit, and this is clearly an issue in the current environment.

And then, also, many of the small businesses are involved in producing goods that are used in the real estate sector. So if you are in a part of the country particularly that has problems in that regard, it is actually a much tougher environment for you as a small business.

Senator THUNE. But do you see this being a problem which certainly is more intense in certain areas of the country, sort of being nationalized? Obviously, if you are a small business in an area where you are really experiencing this mortgage crunch, your availability of credit if you use home equity as a way of financing some of your operations is a problem. But is that starting to impact others, trickling out or having a domino effect——

Mr. MISHKIN. Yes. It is a national problem—think about the household. The household also has lost collateral when the value of their housing goes down, and that means that there is likely to be less spending. Even when households spend, they don't just spend in their own community.

Senator THUNE. Right.

Mr. MISHKIN. They actually spend on goods throughout the country. So indeed, you are exactly right that the problems which started just in one small part of the financial sector have actually spread much more widely in both the financial system and also in terms of the overall economy.

Senator THUNE. Administrator Preston, I know some of the witnesses on the second panel are going to discuss their personal experiences on the subject, but can you tell me what you have heard at the SBA from lenders about the demand for loans?

Mr. PRESTON. Demand is down very noticeably and certainly there are a number of factors we think are driving it. Some of the surveys would indicate that there is a lesser propensity to hire right now, a lesser propensity to invest back in the business. Those are the kinds of things that typically give rise to borrowing needs, and certainly in a slowing economy that is not as surprising.

The other thing I would tell you is we have taken a look at our loan programs back in the early 1990s and from 2000 and 2001, the last couple of times where we have seen a real economic downturn. In both cases, we saw a fairly significant downturn in our lending, which is very much in line with what we are seeing right now. That doesn't mean it is good, but certainly some people have commented anecdotally they thought we were sort of countercyclical and we sort of came into our own. But certainly when we have gone back and looked at the evidence, that is not the case.

Senator THUNE. It has been suggested that there be a lowering of fees as one solution to the credit crunch. Can you tell what effect, if any, lowering of fees on SBA loans has had on loan demand in the past as you have looked at your portfolio over time?

Mr. PRESTON. Our portfolios had very consistent fees for many, many years other than the 2003 and part of 2004 time frame, when there was a shorter-term reduction in fees. Our loan volume actually grew throughout that period of time. But when the fees went up, our loan portfolio continued to grow. So it was sort of in the middle of a longer-term growth period and so when the fees went up, the loan volume did not go down. It continued to go up.

We are overwhelmingly hearing from lenders it is either credit or demand. Now, there are certainly people on the margin who I am sure would like us to lower fees, and obviously it makes them economically somewhat more attractive, but we don't think it is going to have a major impact on volume for a number of reasons.

Senator THUNE. I am sure my time has expired, Mr. Chairman. Thank you.

Chairman KERRY. Thank you very much, Senator Thune.

Senator Snowe.

OPENING STATEMENT OF HON. OLYMPIA J. SNOWE, A UNITED STATES SENATOR FROM MAINE

Senator SNOWE. Thank you, Mr. Chairman. Thank you for holding a very critical hearing that is most timely, given what is taking place in our economy. I appreciate your efforts here today to discuss the credit crunch and the impact it is having on small business and I want to welcome our panelists. Administrator Preston and Dr. Mishkin, thank you very much for offering your views at a crucial time for our nation's economy.

Obviously, small business is an essential and crucial aspect of our well-being economically. It is disconcerting when you see the evidence out there that this downturn is going to be most pronounced on small businesses. I certainly want to make sure that we are doing everything that we can, whether through the Small Business Administration or through Congress. We must work on the issues that we can address and remedy with respect to the use of the loan guarantee programs in easing the restrictions, the lender oversight fees, the process, streamlining it more so it makes it user friendly, and customer friendly.

The other part of this problem right now is in respect to lenders, and that there are so many that are not participating. We see the drop-off in the 7(a) program, more than 368 over the last two years, and a decline in the Express program. It is significant. It illustrates that we have some challenging problems that we could remedy now.

Certainly, the legislation Senator Kerry, and I, and everyone here on the Committee supported would help small business borrowers. This legislation, pending before the Senate, would streamline the process. We would like to execute the Small Business Lending Reauthorization Improvements Act. There are a number of provisions in there that could help and benefit small businesses. We have been trying to negotiate an agreement to get it through the full Senate even though it has passed this Committee unanimously.

I hope the SBA could further streamline their process, and could we not suspend lender oversight fees? These are huge barriers to small businesses accessing the programs and loan guarantees rather than relying on credit cards and home equity loans, which we see as a continuing rise in that direction. It is problematic when you are given the cost and the risks associated with using credit cards and home equity loans. There is no question that this type of business borrowing is going to be far more costly. And it is, given what credit card companies are charging these days and all the different practices that are out there that drive up the costs.

So I would like to explore with you, first of all, Administrator Preston, what could be done immediately. Let us just take the time frame of 45 days in terms of what could be done within your agency, one, to streamline the process, because that is a problem for lenders, and also small businesses trying to use these programs. If you are seeing a drop-off, it could be a number of reasons, but obviously it is the barriers, such as the SBA's excessive paperwork.

The second part this is the lender oversight fees that are also a barrier, which I know have been raised recently. The one on the 7(a) annual lender fees going up to 0.55 from 0.49, and then, of course, the other one is charging lenders $9 million for lender oversight fees in the 7(a) program. That is going to drive people out of this program. It is just going to make it that much more prohibitive in terms of using SBA loans.

So is there something that could be done now, within 45 days, that you could execute? I mean, we have our job to do on this side, there is no question, in getting these bills passed and I think it would help to raise the loan limits and so on. We have tried to expedite that process. Is there anything we could be doing, or you could be doing?

Mr. PRESTON. Well, yes. We are doing a number of things right now which I think are going to be helpful. One of the things we are pushing very hard on is to expedite the roll-out of a highly-simplified process for rural lenders. In fact, we just finished piloting it in Senator Thune's State and five contiguous States.

Many of you recall the Low-Doc product a number of years ago. When Low-Doc was discontinued in 2005, we lost over 400 banks in 2006 in our active lenders. So when you look at when we actually lost lenders, it was from 2005 to 2006 and most of those were Low-Doc lenders. And the reason is clear, it was a simple application and it was easy to do. It wasn't, to your point, difficult to comply with. The problem was it had very high credit losses and was driving costs up in the portfolio.

So what we have done is we said, well, what worked about Low-Doc and what didn't. And we have piloted this program—we call it Rural Lender Advantage, even though it is for any community bank—which is a very simplified form. They can do it electronically. We commit to a very rapid credit decision, turn-around. We have a customer help desk in place, so any small lender who isn't familiar with our programs who doesn't know how to fill it out, we will get on the phone with them. We have trained our entire field network on how to help lenders with their lending program. So they can call our field office for help. And we commit to a quick turn-around.

So we piloted it in that area of the country. We got a lot of feedback from lenders. We had a lot of outreach. They told us how we could make it better. Right now, it is in internal clearance. As soon as it comes out of internal clearance, we are going to do a nationwide roll-out and we will have a very active process to engage small lenders back into our programs.

Senator SNOWE. So when would that take place?

Mr. PRESTON. I would hope that—we are pushing very hard to begin adding regions of the country early next month. Like I said, right now, literally, it is in internal clearance, so I am pretty hopeful it is going to be a good recruiting tool.

The other thing I would mention is——

Senator SNOWE. So that would be the pilot program?

Mr. PRESTON. The pilot——

Senator SNOWE. Is that completed yet?

Mr. PRESTON. The center part of the United States is finished——

Senator SNOWE. It is finished, so then you would execute it nationally?

Mr. PRESTON. We want to roll it out much more broadly. And so, you know, Low-Doc was roughly speaking, ten percent of the number of loans we did.

The other thing is, and I mentioned it before you came in, is last month, we reached out and had sit-down detailed relationship meetings with over 800 lenders to begin to work them through how to use our products more broadly and to get out there and expand what we can do for them.

You have talked about streamlining. I think you are familiar with some of the challenges we have had in our guaranteed purchasing operations, very long backlogs. We are turning those in 22 days. It is a big part of getting people back in our programs, because when they send us a purchase, they want us to honor it.

All across the agency, we are going more to electronic interactions. We are simplifying our processes. We are making our agency much easier to work with, and we have trained about 1,000 people in the field to be better at working with people locally, some of whom are banks. So I really think we are putting shoulder to the wheel to push our programs out.

Senator SNOWE. And have you been able to get any lenders back on board?

Mr. PRESTON. As we closed 2007, we had an increase in lenders. Now that we have finished this round of outreach, once we have this Rural Lender Advantage tool, we are going into very active recruiting mode. So as of the end of last year, yes, not dramatic——

Senator SNOWE. Can you tell us how many?

Mr. PRESTON. I think it was—yes, I can, but if you ask your next question, I will have it to you probably in a second.

Senator SNOWE. Well, I guess the point is we have a very targeted and directed program to enlist lenders back on board, addressing some of the issues that are within your capacity to do so. That is critical. We don't want a fall-off at this crucial point because you can lose small businesses, you can lose jobs. You really have to make a concerted effort to try to get them back on board, because obviously there are problems, and that is what we are going to hear in the second panel, that there are serious problems with the program, not to mention the lender oversight fees, which are a barrier. Can you suspend those fees?

Mr. PRESTON. Those fees, very roughly speaking, right now are about $10 million a year. I am less concerned about the impact of those—not all—the smaller banks don't pay those fees, don't pay the on-site fees. We don't do on-site reviews unless a bank hits a certain size, and so it is not a big cost for the larger banks. It is not a cost at all for the smaller banks.

I will say there is a tier of banks that are small-ish, and I can give you kind of the size—maybe that have to $10 to $25 million in guarantees from us—that I think it is a cost for, and we are working on a project right now to understand if there is a way we can soften the blow for that tier of banks, because the issue is once we have to go on-site and do a review, it becomes expensive. But as you know, we have been working very hard to increase significantly the quality of oversight we do, and as a result, we are going to banks a lot more. We are doing a lot more reviews of their portfolios because, as we have talked in the past in these hearings, it is important for us to make sure we are doing the right kind of oversight.

Senator SNOWE. Do you support the legislation that we are trying to get through in the Senate that passed unanimously from this Committee and has been pending since September? The Small Business Lending Reauthorization. It goes to the heart of all the lending programs.

Mr. PRESTON. Ma'am, I would have to look——

Senator SNOWE. It increases the maximum loan size for the 7(a) loans to $3 million, allows 7(a) bonds to be traded in the secondary market, increases liquidity, simplifies size standard requirements for the 7(a) program, makes it easier for 504 developers to make loans in low-income communities, and addresses a number of other issues. I won't go through them all. But it really would be helpful here to——

Mr. PRESTON. I would be happy at any time——

Senator SNOWE [continuing]. Break the deadlock, I mean. I don't know, is there resistance from the administration on this issue?

Mr. PRESTON. I would be happy to come over at a moment's notice and go through all those provisions with you. I think it has some very good stuff in it and we would love to——

Senator SNOWE. It is too bad that it is an all-or-nothing proposition, that we can't get this legislation through. It is a moment in time where we have to do everything we can to support these programs, boost the economy, help small businesses create jobs. There is no reason for this to be languishing. I know that there are some concerns in the administration, but we ought to be able to work them through and get this done. I mean, it has been languishing since last September.

Mr. PRESTON. Right. I apologize——

Senator SNOWE. In the meantime, so many things are happening out in the economic landscape that are so pivotal to the well-being of small businesses and to their existence. And here is a good example of that. It passed unanimously out of this Committee. That is illustrative of the support that it has. So I just don't understand why we can't get this through. Is there a way of working that out sooner rather than later?

Mr. PRESTON. Like I said, I am not—honestly, I don't know the state of play on the bill and I would be happy to meet with your staff and work through it.

Senator SNOWE. Well, can we—this is important.

Mr. PRESTON. Yes.

Senator SNOWE. I think we really should. Let us get it done. Let us show the "can do" spirit. That is my feeling here. You know, there are so many things going on out there. People need support and help and there is no reason, with a bill that has passed out of the Committee unanimously, that has broad support, that if there are some issues here, we shouldn't be able to address them. But it shouldn't be just, hanging in limbo because the administration has some concerns. We ought to be able to work it through.

Mr. PRESTON. Yes. Frankly, I didn't—I am not sure that our staffs have fully gotten together on it and I am committed to do this——

Senator SNOWE. You will as of today?

Mr. PRESTON. Yes, absolutely.

Senator SNOWE. Well, my staff says you have gotten together multiple times, so——

Mr. PRESTON. All right.

Senator SNOWE [continuing]. Whatever it be, let us change it today.

Mr. PRESTON. Can I just mention one other thing?

Chairman KERRY. Mr. Administrator, can I just say to you, we passed this bill. When you were up here previously I asked you about this. Your staff has never, ever communicated to us any issue whatsoever with the bill. So if you have an issue, we have got to know what it is, and I would like to have an agreement, if I can, with Senator Snowe. We are at Wednesday now. Why don't we say by next Monday, if you have got an issue, would you tell us what it is?

Mr. PRESTON. Yes, absolutely.

Chairman KERRY. Otherwise, you are going to support it, correct?

Mr. PRESTON. We will go through it with you chapter and verse in terms of what we understand the administration's position to be and where we need to go with it.

To your earlier question, Senator Snowe, we had 200 lenders make a loan in the first half of 2008 that did not make loans last year, in the first half of last year, and at the end of 2007, we saw a two percent increase in our lenders. So it is not dramatic, but it is after a period of decline.

Senator SNOWE. Thank you. Thank you, Mr. Chairman.

Chairman KERRY. Can I follow up on that, if I may? I am really concerned about the trend line. You know, since 2005, you have lost 390 lenders. And then for 2008, the pace as we look at it now is about 100 more lenders are on tap to have been lost for the third straight year.

Now, when we talk to these folks, one of the principal reasons that they give us for dropping out of the program is because of the increased fees, lender oversight fees, and the unduly burdensome paperwork. Those are the three things we hear from these banks. We have lost many more participant banks than we have gained. So that is not a great trend line for an entity and a program that ought to be growing and appealing to more and more people.

I think a lot of us feel very strongly, Mr. Administrator, that these fees—you know, when the economy gets tight like this and we all take a look at somebody who is going to be foreclosed—a few weeks ago, Mayor Menino and I hosted a weekend event at the Roxbury High School where, for the first time, we had a whole bunch of home owners who were able to come into a room and we got the ten major lenders and sat them down in private rooms. Everybody was screened. They brought their paperwork with them. And they literally negotiated right there in this high school and people walked out smiling because they were able finally to get somebody on the phone and not have a punch two to go to six, to go to five, and punch one and you don't get anybody. They talked to somebody who actually negotiated.

And the result is they are staying in their home because they are able to afford a fixed-price mortgage at the revalued price that doesn't reflect the predatory practice that—I mean, one of these women was paying a 13 percent mortgage. You tell me any of your friends who are paying 13 percent. Others are paying 9.25 and so forth and about to go up. And these are people, both members of the family working, hard working, playing by the rules, $5,000 a month for their mortgage, and they are about to get kicked out of their home because of the lack of reasonableness.

Now, for those people, the difference between the ARM that would have taken them up and the fixed rate was the difference in their ability to stay in the home. That is true of a lot of small business people who are looking at the potential of taking out a loan or maybe following through with an expansion, but if they look at the fees and they look at the additional fee and things they sort of back off.

And it seems to me in this moment, in the mood we are in where we have got to—we have got to kind of change the psychology of the country. I agree with Senator Snowe. It is a time for people to say, we have got to break this cycle and the way to break it is to restore confidence, and the way to restore confidence is give people a sense that you are on their side and working with them to facilitate their ability, if they have got a going concern and they meet all the other creditworthy issues, that they can stay in there.

So I would ask you to think carefully about this issue of whether or not these fees and other things don't make a difference, particularly since you are losing lenders at a greater rate than you are gaining them and they are telling us the reason they are dropping out is because of the increased fee.

Mr. PRESTON. Let me make a couple of points. I wouldn't underestimate Senator Snowe's point of being an entity that is easy to do business with and streamlined. I would be amazed if any lender group came forward and said over the last year and a half that we hadn't made tremendous strides in being more sensitive to the industry, simplifying our policies. We hadn't updated our policies in over 15 years. They are all updated. They are simplified. Responsiveness to banks that we are purchasing loans from, clarity around how we do business, much greater customer support, much higher quality training of our people to go to banks and help them through their issues. On the side of being an effective, easy-to-use partner that provides great support, I think we have made incredible progress. I really do.

And on the fee side, granted our fees were somewhat lower in 2003 and 2004. I guess the question to think about is when we look at sort of order of magnitude, and generally when we talk about an impact on our fees, we are looking at reducing our up-front fees by a half to one percent. So moving from two points to one point. And the question is, how much is that actually going to drive borrowing behavior with people—how much does that make it affordable to them, by going from two points to one point.

I actually think what we are going to see is a lot more conventional loans coming into our portfolio, many of which lenders would do otherwise. And I have talked to many lenders about this issue and I think that is a very likely outcome of this.

I will say on the lender oversight fees, to your point, Senator Snowe, I do think there are a group of lenders for whom this is a challenge and I think it is kind of the small to medium-sized and I do think we have to look at that. We are reviewing alternatives right now on how we can either make those on-site reviews less frequent or reduce the fees somewhat. But for the small lenders that don't get hit with it and for the large lenders, I think it mostly gets absorbed into the size of their portfolio.

I don't think this is going to be an overwhelming driver of volume, though. I really don't. I think it is going to be engaging the banks by being a good partner and getting the banks to see that our programs help them to make credit decisions that they are not making right now. I think it is a credit issue.

Chairman KERRY. Well, I hear you. I hear what you are saying, but I am not sure that the realities of the marketplace say that that is accurate or that experience does. Let me just refer you. In 2001, after the tax in New York and here, Senator Bond and I pressed and passed legislation after 9/11 to reduce the lender fees by 50 percent because of the jarred economy, et cetera. We had a 50 percent increase in the number—excuse me. We cut by 50 percent. There was a 23 percent increase in lending and SBA did about $2,900,000,000-and-some worth of lending under that guise. I think we went up from 2001, from nine, up to 12 in the next year, and then it was 11 the year after that.

So I think that the evidence is that it makes a difference, and I think when you add it to the other piece, it is problematical. We can argue about it. Obviously, you have a different point of view. But I think the evidence indicates that when money is tight and cash flow is tight and working capital is tight and the economy is uncertain, those fees can make a big difference.

Senator Snowe, do you have any—I want to leave the record open. I want to get the other panel on, and we have some things, so I think it is important to do that.

Mr. PRESTON. Okay.

Chairman KERRY. So I would like to leave the record open for a couple of weeks, if we can, and other colleagues can submit questions.

We are very appreciative to you for taking the time to be here, both of you. I know it is important.

Do you have anybody from your shop, particularly SBA, who are going to stay here?

Mr. PRESTON. Yes, and we will also reach out to your staffs on the bill.

Chairman KERRY. Great. Thank you.

Mr. PRESTON. So I apologize if there has been a disconnect there.

Chairman KERRY. That is terrific. I appreciate it.

If we could ask the second panel to come forward and just take seats and we will get you arranged with names.

Meanwhile, let me just say, this second panel is larger than we usually have and the reason is we really want to get a comprehensive picture of the credit crunch impact on small business. So we are going to hear from Marilyn Landis, who is the President of Basic Business Concepts; then from Robert Mitchell, the founder and CEO of Mitchell and Best Homebuilders; Daniel O'Connell, Secretary of the Massachusetts Office of Housing and Economic Development; and then we will hear from Cynthia Blankenship, Vice Chairman of the Bank of the West; then from Professor Sam Bornstein from Kean University in New Jersey; and finally from the Mayor of Gloucester, Massachusetts, Carolyn Kirk.

We are very appreciative to all of you for your patience and for your distance traveled and for coming here to share with us. I think it is important testimony, and we would like to remind you that if you could try to summarize in about the five minutes, all of your written testimony will be placed in the record as if stated in full.

Mayor, do you want to start off?

STATEMENT OF HON. CAROLYN A. KIRK, MAYOR, GLOUCESTER, MASSACHUSETTS

Ms. KIRK. Sure. Chairman Kerry, Ranking Member Snowe, I thank you for inviting me here today to testify about the impact of the credit crunch on small business. My name is Carolyn Kirk. I am the Mayor of the City of Gloucester, Massachusetts. You may know of Gloucester. The city of about 30,000 residents is located north of Boston and we are America's oldest fishing port. Chartered in 1623, the city has a long and storied history of providing fresh fish throughout the country and beyond. In our 385-year history, Gloucester has lost over 10,000 men to the Atlantic Ocean. The names of those known as lost at sea are painted on a mural on the main staircase at City Hall and also on a memorial on Stacy Boulevard. I invite you all to come and visit our beautiful city if you haven't already.

In Gloucester, the fishing industry has sustained the community and its backbone has been small business. From the ice company that supplies ice to the fishing boats to preserve their catch to the shoreside services that perform boat repair, provide fuel or dockage, small business is the engine that has driven our economy. With the drastic measures taken by the Federal Government in an effort to rebuild fish stocks, the economy in Gloucester is at a crossroads, but it is still driven by small business.

To give a city like Gloucester or any American working-class city whose economy is in transition a fighting chance to survive and thrive, we need your help. Today, I am here to testify about the impact of the credit crunch on small business. The impact is significant and appears in many different forms throughout small businesses in Gloucester. In preparation for my testimony, I asked small business owners in Gloucester to contact me with examples of how the credit crunch is impacting them, and this is a sampling of what I heard.

A number of small business owners state that their customers pay more slowly. An owner of an oil delivery company reports that the vendors that supply oil to him demand immediate electronic payment. However, the homeowners to whom he delivers the oil are slow to pay, leaving him with a cash flow issue, making it difficult to keep enough money in the bank to keep the business going.

A small business owner just starting out financed equipment and materials for the business on credit cards, and the credit card companies are shortening their payment cycle to 22 days. But her clients are slow to pay, or even if they are on a 30-day term, it makes the business owner late in her credit card payments. She says it is a constant battle with the credit card companies and they are the only ones making any money.

Another small business owner cites other factors which are impacting his business, such as inflation. Three years ago, eggs cost seven cents. Now, eggs are 21 cents, which is a 300 percent increase. His monthly electric bill runs an average of $1,000 per month. The impact of his higher costs ultimately result in higher retail prices to the consumer. Across the board, small business owners are feeling the effects not only of the credit crunch, but increases in cost such as utilities, health insurance, or in my city, the cost of water and sewer services, which are skyrocketing.

As I said, Gloucester was chartered 385 years ago. Today, when my engineers replace water lines underground, many of the pipes they pull up are stamped 1902. My city has an aging infrastructure. A catastrophic failure in our drinking water system or our sewage treatment plant could cripple the city and bankrupt our citizens, and we are under a Federal consent order to separate our sewage from the storm water. This project is costing the city tens of millions of dollars and the rate payers, who are also our small businesses, are footing the bill. This is simply not sustainable for our local economy. Gloucester is committed to the Clean Water Act, but we need Federal relief in the form of direct grants. It bothers me to hear about infrastructure investments our country is making around the world when my own city is crumbling around me and my residents and small businesses are tapped out.

I ask that when you deliberate about how to address the impact of the credit crunch on small business, that you look at all of the factors that are making it difficult for small businesses to survive. When the Congress passes a mandate that is unfunded, it is the small business owner and the taxpayer that picks up the slack. Unfunded mandates in education have caused my city to divert spending to mandated education programs. We don't spend any money on athletic programs. Rather, the students and the parents turn to the small businesses for donations, auction items, and money.

Successful small businesses are resilient. Many can survive the credit crunch. But they are also dealing with inflation. They are dealing with the more expensive municipal services because of spending on infrastructure and the increased costs of delivering those services. They are dealing with schools who have their hand out, always looking for money. And my observation when I look at it is that we are creating private wealth and public squalor and many small business owners are just caught in the middle. We need to create wealth, jobs, and opportunities for our small businesses and reinvest and rebuild the domestic economy.

I applaud the work of this Senate committee and I want to just let the record show that I support the initiatives that you are trying to push through this Congress. I urge you to continue your dedicated work towards reinvesting in America's economy and to keep in mind the overall impact of the fiscal condition facing our cities and towns, which is how a citizen experiences this country, as you make your decisions in the 110th Congress.

Thank you for the opportunity today.

[The prepared statement of Ms. Kirk follows:]

Testimony of

Carolyn A. Kirk
Mayor
Gloucester, Massachusetts

Senate Committee on Small Business and Entrepreneurship
110th Congress
Wednesday, April 16, 2008 2:30pm
"The Impact of the Credit Crunch on Small Business"

Chairman Kerry, Ranking Member Snowe, and distinguished Members of the Committee, I thank you for inviting me here today to testify about the impact of the credit crunch on small business.

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In preparation for my testimony, I asked small business owners in Gloucester to contact me with examples of how the credit crunch is impacting them, and this is a sampling of what I heard:

A lawyer in private practice observes that with the price of homes falling, normally he would see an upswing in real estate closings. However, underwriting standards have tightened so much that many buyers don't qualify so there hasn't been the increase in business that he would normally see in this type of cycle.

A number of small business owners state that their customers pay more slowly. An owner of an oil delivery company reports that the vendors that supply oil to him demand immediate electronic payment. However, the homeowners to whom he delivers the oil are slow to pay, leaving him with a cash flow issue making it difficult to keep enough money in the bank to keep the business going.

A small business owner just starting out financed equipment and materials for the business on credit cards, and the credit card companies are shortening their payment cycles to 22 days. But her clients are slow to pay, or even if they are on a 30-day term, it makes the business owner late in her credit card payments. She says, "it is a constant battle with the credit card companies, and they are the only ones making any money."

Another small business owner cites other factors which are impacting his business such as inflation. Three years ago an egg cost 7cents. Now eggs cost 21cents which is a 300% increase. His monthly electric bill runs an average of $1000 per month. The impact of his higher costs ultimately results in higher retail prices to the consumer.

Across the board, small business owners are feeling the effects of not only the credit crunch, but increases in costs such as utilities, health insurance for their employees, or in my city, the cost of water and sewer services which are skyrocketing.

As I said, Gloucester was chartered 385 years ago. Today, when my engineers replace water lines underground, many of the pipes they pull up are stamped 1902. My city has an aging infrastructure. A catastrophic failure in our drinking water system, or our sewage treatment plant could cripple the city, and bankrupt our citizens. And we are under a Federal Consent Order to separate our sewage from the storm water. This project is costing the city tens of millions of dollars, and the ratepayers who are also our small businesses are footing the bill. This is simply not sustainable for our local economy.

Gloucester is committed to the Clean Water Act but we need Federal relief in the form of direct grants. It bothers me to hear about the infrastructure investments our country is making around the world when my own city is crumbling around me, and my residents and small businesses are completely tapped out.

I ask that when you deliberate about how to address the impact of the credit crunch on small business, that you look at all of the factors that are making it difficult for small businesses to survive.

When the Congress passes a mandate that is unfunded, it is the small business owner and the taxpayer who picks up the slack nevertheless. Unfunded mandates in education, for example, have caused my city to divert spending to mandated education programs. We do not spend one dime out of the operating budget on athletic programs as a result. Instead, students and parents turn to the small business community for donations, as one strategy.

Successful small businesses are resilient. Many could survive the credit crunch. But they are also dealing with inflation. They are dealing with more expensive municipal services because of spending on infrastructure, and increased costs for delivering those municipal services. They are dealing with schools who have their hand out, always looking for an item to be auctioned, or money. It seems to me that in this country we are creating private wealth and public squalor with small business owners, many of modest means, caught in between.

We need to create wealth, jobs and opportunities for our small businesses, and reinvest and rebuild the domestic economy. I applaud the work of the Senate Committee on Small Business and Entrepreneurship, and I support the $100 million increase for the Small Business Administration in the FY09 Federal budget. I urge you to continue your dedicated work towards reinvesting in America's economy, and to keep in mind the impact of the overall fiscal picture when making your decisions in this 110th Congress.

Thank you for the opportunity to address you today.

Chairman KERRY. Well, thank you, Mayor. That was a very graphic and important, eloquent description of the problems that you face and I am happy to report I have enjoyed that wonderful City Hall, which is really very beautiful and very moving. I was there for the dedication of the memorial, so it is nice to be reminded of both.

Senator Snowe, I know, has a huge affinity for everything you are talking about because she has great fishing ports and villages, too, so we are happy to welcome you.

Ms. KIRK. Thank you.

Chairman KERRY. Have you been to Gloucester? I have been to Camden. [Laughter.]

Senator SNOWE. Look at that. He set me up for that one. [Laughter.]

No, but I will visit there.

Chairman KERRY. There you go.

Professor Bornstein, thanks. I have to step out, incidentally. I am going to be able to hear you outside, but I have got to join a conference call for a few minutes, but just continue on. Senator Snowe will chair and we will continue through. You can go ahead.

STATEMENT OF SAMUEL D. BORNSTEIN, CPA, MBA, BME, PROFESSOR OF ACCOUNTING AND TAXATION, SCHOOL OF BUSINESS, KEAN UNIVERSITY, UNION, NEW JERSEY

Mr. BORNSTEIN. My name is Sam Bornstein. I am a Professor of Accounting and Taxation at Kean University. Good afternoon, Chairman Kerry, Ranking Member Snowe, and members of the committee. Thank you for inviting me to discuss the credit crunch and its impact on small business.

For the past 30 years, I have been a professor of accounting and taxation, as well as a CPA and consultant in public practice. This unique combination of experience as an educator and a practitioner has given me an interesting perspective and insight into this topic. Since 2000, I have researched the small business failure phenomenon. In recent years, my research has evolved into the impact of the subprime mortgage crisis on small business.

The credit crunch can trace its beginnings to the inception of subprime mortgages. During the period of mid–2002 to September 2005, when interest rates were exceptionally low and there was a booming real estate market, we experienced the biggest refinancing boom in history. Loan underwriting standards were often ignored. Even the least credit-worthy borrower had access to this easy money. Loans were made regardless of bad credit histories and low or no documentation of income. Small business owners were drawn into subprime mortgage financing by the ease in which they could access cash to quench their continuous need for capital.

Studies showed that small business owners often used their homes as collateral on small business loans. For many small business owners, refinancing their homes was the easiest way to meet their cash flow needs. Small businesses chose this option over other traditional sources of financing, such as regular commercial or SBA-guaranteed loans, because home equity loans did not require the same level of cumbersome paperwork, including financial statements, income documentation, and an established credit history.

With the subprime mortgage crisis, the resulting credit crunch, and the slowing economy, small business owners were hit hard when home equity financing dried up. Credit cards became the number one source of small business financing. Credit cards facilitate easy access to capital, especially at the inception of a business. But, there is a downside! In a 2007 study of the bankruptcy filings of small business owners, there was a striking level of credit card debt for small businesses in bankruptcy. The average outstanding credit card debt for small business owners in bankruptcy exceeded $55,000, while for small business owners not in bankruptcy, it was only $17,000.

Although credit card usage can be an effective means by which to acquire capital, managing this type of debt requires careful planning. There are risks involved which the small business owners are not prepared nor financially knowledgeable to handle. Too much debt is the major cause of small business bankruptcy.

In the course of my research, I discovered a connection between small business failure and the subprime mortgage crisis, which was confirmed by a 2007 study of the bankruptcy filings of small business owners. The study found that in bankruptcy, small business owners had approximately $200,000 more total debt than wage earners. This can be attributed to their home equity refinancing during the subprime mortgage era. As many as 80 percent of Americans refinanced their homes during that time, included in this statistic are small business owners who cashed out the equity in their homes to capitalize their newly-created or existing businesses.

A landmark study of consumer bankruptcy concluded that small business failure was the cause of personal bankruptcy of one-in-five individuals, and they accounted for more than half of all debts in bankruptcy. The Federal Reserve Bank of Cleveland research study found that there was a disturbing correlation between bank failures and small business failure.

In business, you can't manage if you can't measure. The antidote to small business failure is the knowledge and understanding of practical accounting and its tools and techniques, which provide the business owner indications of where the business has been, where it is, and where it is going.

In a nationwide survey of approximately 1,000 small business owners and managers, whose businesses failed, when asked as to why their small businesses failed, more than half of the individuals interviewed said that "lack of financial management expertise" was the primary cause.

In conclusion, credit alone does not guarantee small business success. With the availability of credit, there is an urgent need for financial literacy education. Small business plays a significant role in our economy. In this time of tight credit and economic downturn, it is important not only to facilitate access to capital, but financial literacy education should also be recognized as vital to the survival of small business. The Small Business Administration is in the best position to consider new and innovative approaches to deliver effective financial literacy education to small business. With the proper understanding and knowledge of accounting and its tools and techniques, small businesses will avoid the greatest threat to their survival, insolvency and bankruptcy.

[The prepared statement of Mr. Bornstein follows:]

U.S. Senate Committee on Small Business and Entrepreneurship
The Impact of the Credit Crunch on Small Business

Testimony of
Samuel D. Bornstein, CPA, MBA, BME
Professor of Accounting and Taxation
School of Business, Kean University

April 16, 2008

Introduction:

Good afternoon, Chairman Kerry, Ranking Member Snowe, and members of the Committee. Thank you for inviting me to discuss the credit crunch and its impact on small business.

For the past 30 years, I have been a Professor of Accounting and Taxation, as well as a CPA and Consultant in public practice. This unique combination of experience as an educator and practitioner has given me an interesting perspective and insight into this topic. Since 2000, I have researched the small business failure phenomenon. In recent years, my research has evolved into the impact of the subprime mortgage crisis on small business.

Background:

The credit crunch can trace its beginnings to the inception of subprime mortgages. During the period of mid 2002 through September 2005, when interest rates were exceptionally low and there was a booming real estate market, we experienced the biggest refinancing boom in history. Loan underwriting standards were often ignored. Even the least credit-worthy borrower had access to this easy money. Loans were made regardless of bad credit histories and low or no documentation of income. This "perfect storm" where both lender and borrower were happy, prompted easy access to cash.

As many as 80 percent of Americans refinanced their homes during that time, included in this statistic are small business owners who cashed-out the equity in their homes to capitalize their newly created or existing businesses. Interest rates on adjustable rate loans dropped to under 4 percent, while some homeowners opted for fixed rates as low as 5 percent. Furthermore, as a result of the newly created concept of securitization, lenders were eager to sell-off these loans, thereby giving them a new pool of cash from which to make more loans. For many small business owners, refinancing their homes was the easiest way to meet their small business cash flow needs. Small firms chose this option over other traditional sources of financing, such as regular commercial or SBA guaranteed loans, because home-equity loans did not require the same level of cumbersome paperwork, including financial statements, income documentation, and an established credit history, as business loans.

Small business owners were drawn into subprime mortgage financing by the ease in which they could access cash to quench their continuous need for capital. They were attracted by the initially enticing "teaser rates" and low monthly mortgage payments and were not concerned about the resets that would follow in two to three years, which would spike the interest rates and increase their monthly payments. Small business owners assumed that they could avoid these higher monthly mortgage payments by either selling their homes, at a substantial profit, or refinancing their mortgages at the anticipated lower rates.

While interest rates were low and the small business owner's main underlying asset, his or her home, was appreciating in value and easily sold, the small business owner had access to cheap capital and took advantage of this unique opportunity. However, this "house of cards" collapsed when interest rates rose and the real estate market bubble burst. This also caused the collapse of the securitized investment market, which meant the end to easy liquidity for lenders that resulted in the credit crunch. Small business owners were hit hard when both home equity and securitization dried up as sources of financing.

Small Business: Home Mortgages and Home Equity Loans

A nationwide study of current small business owners indicated that 54.2 percent of those responding to the poll used their residence as collateral. The study was conducted by the Small Business Research Board (SBRB) and co-sponsored by Business Today Magazine (Jan 17, 2008). More than 450 small business owners and managers participated in the SBRB/Business Today study entitled, "Small Business Lending Relationship and Loan Requirements Study."

In 1996, bankers estimated that at least 90 percent of first-time small business owners used their homes as collateral on small business loans. This statistic is not so surprising if you consider that a new business often does not have a track record or sufficient assets to serve as collateral for the entire loan. Unfortunately, with the subprime mortgage crisis, the resulting credit crunch, and the slowing economy, these small business owners are experiencing financial distress due to lack of liquidity.

At one time, lenders would offer in excess of 95 percent of a home's value to borrowers with credit scores as low as 600. However, given the current credit crunch, lenders are demanding higher credit scores for home equity loans. This has restricted home equity as a source of capital for small businesses.

An August 2007, Middle Tennessee State University study found that 18.8 percent of small businesses in the state used home-equity loans for startup capital. An August 2007, Discover Small Business Watch survey found that 30 percent of small business owners had used home-based loans for funding. In the Tennessee study, home equity loans accounted for an average of 43.1 percent of startup funding for businesses that used them. Unfortunatèly, home-equity funding is becoming impossible to obtain.

Small Business: Credit Card Debt

Credit cards are now the No.1 source of small business financing. Credit cards facilitate easy access to capital, especially, at the inception of a business. In fact, banks and lending institutions are now targeting small businesses for credit card spending, seeing that small business owners are unable to have access to needed capital that was previously provided by borrowing against their main source of equity, their homes. With the nation suffering through the subprime mortgage meltdown and the resulting credit crunch, the small business owner has no choice but to access capital through credit cards.

Small businesses require access to capital especially for startups and existing businesses. Up until the early 1990s, only about 16 percent of small business owners used credit cards for capital. In the 2007 National Small Business Association (NSBA) Annual Survey, more than 44 percent said they had used credit cards for financing over the preceding year. Of those, 13 percent are carrying more than $25,000 in credit card debt, and 36 percent are carrying more than $10,000.

The easy availability of credit cards has been beneficial. Without them, many small businesses would have no line of credit at all to finance purchases or cover cash flow shortfalls. Most surveys of entrepreneurs show that credit cards are among the most popular sources of startup financing.

But there is a downside. More than 70 percent of business owners carry a month-to-month balance, up from 64 percent in 2000. This poses a dangerous situation when small business owners resort to making the "minimum payment" on their credit card debt, without realizing that this belies the fact that their debt is rising and may be leading them into insolvency and bankruptcy.

Bankruptcy studies show that small business owners in the bankruptcy admitted that credit card debt was the source of as much as one-third of their business financing at the time of business formation. Although, credit card usage can be an effective means by which to acquire capital, managing this type of debt requires careful planning. There are risks involved which the small business owners are not prepared nor financially knowledgeable to handle.

Too Much Debt: The Major Cause of Small Business Bankruptcy

Debt can overwhelm a small business and lead to financial distress. According to a study of the bankruptcy filings of small business owners conducted by Professor Rafael Efrat (2007), the data suggests that small business owners in bankruptcy had overburdened their businesses with debt. The study found that the total outstanding debt (including mortgage, home equity, credit cards, etc.) for the small business owners averaged $259,134, while wage earners in the bankruptcy sample reported average outstanding debt of $58,250. The approximately $200,000 of additional debt may have been acquired from mortgages and home equity loans.

Since credit card debt was becoming a growing credit source for small business owners since the 1990s, the study sought to evaluate the level of credit card debt for small businesses in bankruptcy. The results were striking. The average outstanding credit card debt exceeded $55,000, while for small business owners not in bankruptcy, it was only $17,000. The study also indicated that small business owners had more than double the amount of credit card debt as compared to the wage earners. Thus, this study illustrated that there was a greater reliance by small business owners on credit card debt to finance their business operations.

One-in-Five People in Bankruptcy Is A Failed Entrepreneur.

A landmark study uncovered evidence of the high rate of small business failure as contributing to the bankruptcy of individuals. The bankruptcy filings for individuals make no distinction between wage earners and small business entrepreneurs. It is difficult to distinguish between the two groups. This study was entitled, "As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America," by Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook. It took six years to conduct and was the most extensive empirical study of consumer bankruptcy ever undertaken and gave insight into small business failure.

The study concluded that small business failure was the cause of personal bankruptcy of one-in-five individuals. Small business entrepreneurs were nearly three times more likely to go into bankruptcy. Considering that small business entrepreneurs failed at a rate of one-in-five of the bankrupts, they accounted for more than half of all debts.

Correlation between Small Business Failures and Bank Failures

Small business failure has the potential to exert a devastating effect on our economic system by contributing to the surge in bankruptcies, the high level of credit card debt and delinquencies, and bank failures.

According to a research study (September 1990) commissioned by The Federal Reserve Bank of Cleveland entitled: "Underlying Causes of Commercial Bank Failure in the 1980s," the report concluded that banks that failed between 1982 and 1989 tended to be located in states with higher small business failure rates than those of the nonfailed banks. This is the most recent study of its kind.

Credit Alone Does Not Guarantee Small Business Success

With the availability of credit, there is an urgent need for financial literacy education. This topic was addressed by Federal Reserve Chairman Bernanke in his speech at the Community Affairs Research Conference, Washington, D.C., on March 30, 2007, entitled, "The Community Reinvestment Act: Its Evolution and New Challenges."

Chairman Bernanke referred to the need for financial education as it related to the Community Reinvestment Act (CRA). He recommended that counseling and financial education should be given more weight in CRA examinations as services complementary to lending.

Chairman Bernanke stated that the CRA has enabled lower-income communities to have access to credit, which has resulted in an increase in homeownership rates, (Joint Center for Housing Studies, 2006). However, the subprime mortgage crisis illustrated the fact that, "more lending equals better outcomes for local communities, may not always hold."

Financial Literacy for Small Business: You can't manage if you can't measure

Small business owners require an understanding of debt management and the tools and techniques that will help them monitor their liquidity, solvency, and profitability. This does not imply that all borrowing is bad, but it does imply that there is a need to be able to measure and monitor the level of debt so as to avoid going down the slippery slope towards insolvency and bankruptcy.

The antidote to small business failure is knowledge and understanding of practical accounting and its analytical tools and techniques, which provide the business owner indications of where the business has been, where it is, and where it is going. The small business owner can and should be taught to analyze accounting and financial data, which could mean the difference between success and failure. Practical accounting can help diagnose small business health. Failures can be predicted and businesses can be saved when their problems are detected in time.

The leading cause of small business failure is a lack of financial literacy. This apparent weakness was highlighted in a National Federation of Independent Business (NFIB) National Small Business Poll (2006) conducted by Mr. William J. Dennis, Jr. The survey concluded that small business owners were lacking in the basic concepts of accounting and may not be using all the management tools available to them. This lack of accounting knowledge may cause "unpleasant surprises" that can force small firms to close their doors.

Various studies of the reasons for small business failure inevitably show poor or careless financial management to be the most important cause:

• A nationwide survey of approximately 1,000 small business owners and managers, whose businesses failed, conducted at the University of Texas found that more than half of the individuals interviewed said "lack of financial management expertise" was the primary cause of their small business failure.

• According to testimony offered before the Securities & Exchange Commission's Government-Business Forum, "One primary cause of the high failure rate for small businesses is a lack of knowledge on the part of owners and managers about accounting – particularly management accounting and internal control."

• The Dun & Bradstreet Business Failure Record indicated that "incompetence, unbalanced experience, and lack of managerial experience creates problems in areas such as operating expenses, receivables, and inventories."

Small business owners lack internal financial expertise because of the size of their enterprises. The owner is wearing five hats. He doesn't have a CFO, and the operations manager tends to be an outside accountant.

Nearly everyone who has any experience with small business recognizes that the average small business borrower often needs improved management skills just as much as he or she needs access to credit. Most small business owners know how to produce the product or deliver the service they're offering, but they may not know how to run their business and manage their cash flow.

According to Dun & Bradstreet, businesses with fewer than 20 employees have only a 37 percent chance of surviving four years and only a 9 percent chance of surviving 10 years. Restaurants have only a 20 percent chance of surviving two years. The failure rate for new businesses seems to be around 70 to 80 percent in the first year, and only about half of those that survive the first year will remain in business the next five years.

There currently is an inadequate appreciation of the manner in which accounting functions – or at least could function – in the control, conduct, and understanding of small business management, and how it can be used to lower the small business failure rate. The small business owner often lacks an adequate appreciation of accounting, which leads to misunderstanding and lost opportunities. The difficulty lies not in the failure to understand accounting processes as in the failure to appreciate how accounting gives small business the management tools they need to successfully handle daily operations and long term growth.

Conclusion

Subprime mortgages have significantly impacted small businesses by facilitating the access to capital. The demise of subprime mortgages has caused a liquidity crisis for lending institutions and the resulting credit crunch. The subprime mortgage crisis has forced many small businesses to seek liquidity through the use of credit cards, which have the least restrictions and documentation. The high level of debt has been a contributing factor to small business bankruptcies, and small business failure has been the cause of bankruptcy for one in five petitioners.

Small business plays a significant role in our economy. Easy access to credit is a major requirement for small business success. In this time of tight credit and economic downturn, it is important not only to facilitate access to capital, but financial literacy education should also be recognized as vital to the survival of small business.

The Small Business Administration is in a good position to consider new and innovative approaches to deliver effective financial literacy education to small business. With the proper understanding and knowledge of accounting and its tools and techniques, small businesses will avoid the greatest threat to their survival -- insolvency and bankruptcy.

Senator SNOWE [presiding] Very compelling Thank you, Mr. Bornstein.

Mr. BORNSTEIN. Thank you. Thank you very much.

Senator SNOWE. Ms. Blankenship.

STATEMENT OF CYNTHIA L. BLANKENSHIP, VICE CHAIRMAN AND CHIEF OPERATING OFFICER, BANK OF THE WEST, IRVING, TEXAS

Ms. BLANKENSHIP. Thank you. Mr. Chairman, Ranking Member Snowe, and members of the committee, I am Cynthia Blankenship. I am Vice Chairman and Chief Operating Officer of Bank of the West in Irving, Texas. I am also Chairman of the Independent Community Bankers of America. I am pleased to appear today on behalf of ICBA and its nearly 5,000 members nationwide to present the views of community bankers on the credit markets and small business lending.

Bank of the West is part of a two-bank holding company with assets of $250 million. We have eight locations in the Dallas-Fort Worth area and serve the small business community with a strong focus on SBA lending. Bank of the West has been a long-time partner with the Small Business Administration and is strongly committed to helping small businesses and our communities by using the 7(a) and 504 loan programs. Bank of the West has more than $8 million in loans in its portfolio and it services these loans. This represents nearly five percent of our total loans.

Credit availability is the lifeblood of our economy. Unfortunately, the broad credit markets are still sorting out problems caused by the subprime meltdown and toxic investments made by many of the largest financial institutions. The current turmoil in our economic and financial markets nationwide raises genuine concerns about the availability of much-needed capital for small business. While much focus has been on helping the housing sector, policy makers must also focus on the needs of the small business sector during this economic slowdown.

At a time when the economy is faltering and credit is becoming more difficult for small business, a sharp decline in the number and dollar amount of SBA loans is troubling. The SBA loan program should act to bolster small business credit in economic downturns. Instead, the number of SBA loans being made is plummeting. Against the long-term protest of the community banking sector, increased SBA loan fees, reduced staff budget funding, elimination of the successful Low-Doc program, and increasing regulatory burdens have all hobbled the SBA's viability when it is needed most.

Simply stated, costly and negative changes to the SBA loan programs have forced hundreds of community banks to drop out of the SBA programs while a handful of the nation's largest banks further dominate SBA lending. The number of lenders making at least one SBA 7(a) loan has dropped almost in half, from 5,288 in 2001 to less than 2,700 today. While there are more than 8,500 FDIC-insured banks, just ten banks were making 60 percent of all SBA loans. The top 25 banks were making two-thirds of all SBA loans.

This gross imbalance has come home to roost. Many of these same largest financial institutions have tripped up on the toxic investments and subprime lending. Consequently, they have been forced to pull in their lending across the board, which includes small business and SBA lending.

Conversely, despite media dominance about a credit crunch, common-sense community bank lenders are very much alive and well, with capital to lend to small businesses. However, the high fees and other SBA program obstacles must be reversed to preserve the affordability for SBA loans for banks and small business borrowers alike.

Now, more than ever, it is vital that the SBA program is robust. During this challenging economic climate, the ICBA respectfully offers several recommendations to help boost SBA programs. These recommendations include: Offering a super-SBA 7(a) loan program for one year as an economic stimulus to help business access needed capital; restoring a reasonable budget appropriation of $250 million to help lower the sharp fee increases on both 7(a) lenders and borrowers; enacting the pending SBA reauthorization legislation; enacting the Small Business Lending Stimulus Act of 2008, S. 2612, that would lower SBA loan fees similar to what was done to help small businesses post–9/11; permanently reinstating the successful Low-Doc program.

The ICBA believes these recommendations will reinvigorate the much-needed SBA lending to boost our economy. GDP growth slowed to a minuscule 0.6 percent in the fourth quarter of 2007. Unemployment has jumped 5.1 percent, and small business optimism is plummeting. Soaring energy costs are further challenging many small businesses. Changing economic times call for policy responses that will address not only Wall Street, but also small businesses on Main Street.

In conclusion, many of our nation's small businesses are facing difficult economic times and obtaining credit is getting more problematic. Boosting small business activity is exactly what is needed to turn the economy around. Community banks, like Bank of the West, are well positioned and prepared to help. However, we must ensure that lenders' and borrowers' SBA program fees are reasonable.

ICBA sincerely thanks you for the opportunity to testify.

[The prepared statement of Ms. Blankenship follows:]

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

Cynthia Blankenship
Vice Chairman/COO, Bank of the West

On behalf of the
Independent Community Bankers of America

Before the

United States Senate
Committee on Small Business and Entrepreneurship

Hearing on
"The Impact of the Credit Crunch on Small Business"

April 16, 2008
Washington, D.C.

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Mr. Chairman, Ranking Member Snowe, and members of the committee, I am Cynthia Blankenship, Vice-chairman and Chief Operating Officer of Bank of the West in Irving Texas. I am also Chairman of the Independent Community Bankers of America.[1] I am pleased to have this opportunity to present the views of the nation's community bankers on the credit markets and small business lending. Community banks are independently owned and operated and are characterized by personal attention to customer service and lending to small business.

ICBA represents 5,000 community banks throughout the country. Bank of the West is part of a two-bank holding company with assets of $250 million. We have eight locations in the Dallas/Fort Worth metroplex. We serve the small business community with a strong focus on SBA lending and real estate. The other institution in the holding company is the Bank of Vernon with assets of $30 million located in Vernon, Texas which is an agricultural community.

Bank of the West has been a long-time partner with the Small Business Administration and has been strongly committed to helping small businesses in our communities using the SBA 7(a) and 504 loan

[1] *The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

programs. Bank of the West has more than $8 million in SBA loans in its portfolio, and it services these loans. This represents nearly 5% of our total loans.

Summary of Testimony

Credit fuels our economy and the broad credit markets are still sorting out many problems. The current turmoil in our economic and financial markets nationwide raises genuine concerns about the availability of needed capital and credit for small business. As the Administration and Congress continue to address the problems in the housing and housing finance sectors, policymakers must also focus on the needs of the small business sector during this economic slowdown. At a time when the economy is faltering, a sharp decline in the number and dollar amount of Small Business Administration loans is troubling. The SBA loan programs should act to bolster small businesses credit in economic slowdowns. Instead, the number of SBA loans being made is plummeting.

Against the long-term protests and advocacy of the community banking sector, sharp increases in SBA loan fees, reduced budget funding and staff, the elimination of the successful "Low-Doc" program, and increasing regulatory burdens all have hobbled the SBA's viability when it is needed most. Simply stated, costly and negative changes to the SBA loan programs in recent years have forced hundreds of community banks to drop out of the SBA programs while a handful of the nation's largest banks further dominated SBA lending. While there are more then 8,500 FDIC insured banks, just ten large banks made nearly 60 percent of all SBA loans. The top 25 banks originate nearly two-thirds (67%) of all SBA loans. This gross imbalance is a recipe for problems.

Unfortunately, many of the these largest financial players have tripped-up on toxic investments and sub-prime lending and have been forced to pull in their lending across the board -- including small business and SBA lending. Conversely, despite the dominant media coverage about a "credit crunch," common-sense community bank lenders are very much alive and well with capital to lend to small businesses.

However, the high fees and other program structure obstacles associated with SBA programs must be reversed to preserve the affordability and workability of SBA lending for banks and small business borrowers alike. Additionally, bank regulators will insist on tightening lending standards across the board during this economic slowdown. Given the declining employment numbers and troubled credit markets, small business access to capital is critical to keeping the economy's gears turning. To that end, SBA programs should serve a critical role. They supply nearly one-third of the long-term capital to small business. Now more than ever it is vital that SBA program be robust. However, a sharply declining number of SBA lenders and loans is the disturbing trend we see. The ICBA respectfully offers several recommendations to help boost SBA programs most widely used by lenders and small businesses in this challenging economic climate. These recommendations include:

- The Small Business Administration should offer a "Super SBA 7(a) loan program" for one year as an economic stimulus to help small business access needed capital. ICBA's nine-point economic stimulus plan advanced to Congress in January recommends a "Low-Doc," expedited 7(a) loan program with a 85% guarantee, and lender and borrower fees reduced to half of their current level for small business loans up to $250,000.

- Restore a reasonable budget appropriation of $250 million to help offset and lower the recent sharp fee increases on both 7(a) lenders and borrowers.

- Quickly enact the pending SBA reauthorization legislation and improvements in the "Small Business Lending Reauthorization and Improvements Act," (H.R. 1332 & S. 1256).

- Quickly enact the "Small Business Lending Stimulus Act of 2008," (S. 2612) that would lower SBA loan fees similar to the successful policy implemented to help the economy and small businesses post "9-11."

- Boost the SBA budget which has been cut nearly in half in the past six years.

- Permanently reinstate the successful SBA "Low-Doc" program to better meet the needs of small business borrowers.

- Reinstate the availability of combination ("piggyback") financing to help serve small businesses with larger borrowing needs.

- Apply additional SBA budget resources to better staff and support regional SBA offices to serve the thousands of non-PLP, non-CLP community lenders available to deliver SBA loans to deserving small businesses nationwide.

Small Business is Vital to Economic Strength

Small businesses are vital to the strength of our economy and employment. Small businesses represent a whopping 99% of all employer firms and employ half of the private sector workers. There are more than 26 million small businesses in the U.S. Small businesses have created 70 percent of the net new jobs over the past decade. Community banks are essential to the strength and success of small businesses nationwide. Community banks like Bank of the West specialize in small business relationship lending. Community banks stick with their local communities and small business customers in good times and in bad. Notably, for their size, community banks are disproportionately large small business lenders. While community banks represent about 12% of all bank assets, they make 20% of all small business loans.

Because small businesses are integral to our economic strength, ICBA believes it is urgent to properly meet the credit needs of small businesses as the economy has softened and employment levels have declined for three straight months. The Federal Reserve has taken unprecedented actions to slash interest rates, provide liquidity, and recently put $29 billion of private sector assets on its (taxpayers') balance sheet to assist large financial firms JPMorgan Chase and Bear Stearns and to keep the credit markets functioning. GDP growth slowed to a minuscule 0.6 percent in the fourth quarter of 2007. Unemployment has jumped to 5.1 percent in March as a result of three consecutive months of declining payroll jobs. Small business optimism is plummeting and credit availability is a genuine concern. In March, the National Federation of Independent Business index of small-business optimism dropped to its lowest level since it began this survey in 1986. Soaring energy costs are challenging many small business budgets and profit margins. The January Federal Reserve senior loan officer opinion survey shows that large banks continue to tighten lending standards for households and businesses. The report is discouraging as tighter lending standards will reduce the availability of credit for small businesses and work to further weaken a struggling economy. Therefore, the federally guaranteed SBA loan programs should work to counter tightening credit markets and help provide funding to small businesses in this more difficult economic climate when they need the program the most. Declining SBA loan volume tells us it is not.

SBA Lending Invaluable

The SBA loan programs are a success story where thousands of small businesses that otherwise would not have had access to capital are funded. However, recent budget cuts, sharp fee increases on both lenders and borrowers, and the elimination of the successful Low-Doc program have undermined the full potential of the SBA loan programs. These and other negative changes have caused a disturbing decline in the number of community lenders actively participating in the SBA loan programs. Today, just the top 10 SBA lending banks make nearly 60 percent of all SBA loans. This in turn jeopardizes the ability of interested community lenders to reach a wide variety of deserving small business borrowers and geographic areas with affordable and flexible SBA loan programs.

Banks could be extending more SBA loans to meet the needs of small businesses during this economic slowdown. However, the number of SBA loans is actually falling sharply. As of the end of March 2008, the year-over-year number of SBA 7(a) loans was down more than 17% and the dollar amount down nearly 9 %. The SBA 504 loan program is also in decline. This is unacceptable if the SBA program is to properly support small business lending needs and bolster economic strength. We need more small business lending not less.

Community Banks are Strong Supporters of SBA Lending

Bank of the West strongly supports the work of the Small Business Administration and actively participates in the SBA's lending programs, specifically the flagship 7(a) and the 504 loan programs.

Community lenders like Bank of the West are proud to work with the SBA in helping supply needed capital to small businesses across our nation, especially now when the economy is weak and many large, money-center banks are cutting back sharply on small business lending. Whether located in small towns, suburbia or big city neighborhoods, community banks grow our towns and cities by funding small business using local dollars. Community banks are one of the key sources of credit and other financial services to small business, the most prolific job creating sector of our economy.

Community-based banks form the building blocks of our nation's communities by providing small business capital and credit to all geographic regions of the country. They have played a vital role in the stability and growth of each of the fifty states by providing a decentralized source of capital and lending. This wide dispersion of our nation's assets and investments helps preserve the safety, soundness, fairness, and stability of our entire financial system.

I want to make it very clear that the SBA guarantee loan programs are unique and extremely valuable in providing needed long-term capital to small business. The SBA loan programs truly represent a success story of how the federal government, working with private sector lenders, can fund small businesses that otherwise would not have had access to capital. The SBA 7(a) loan program provides 30 percent of all the long-term small business lending.

SBA Loans Serve Unique Role

Lenders need to match short-term deposits with short-term small business loans. While the typical commercial small business loan has a maturity of one to three years, SBA 7(a) loan maturities average 12 or more years. Importantly, SBA lending allows longer loan terms up to 25 years. This lowers the entrepreneur's loan payments and frees up needed cash flow to start or grow the small business. As small businesses do their best to weather the current difficult economic climate, the longer loan term offered by an SBA loan is a huge help.

The SBA 7(a) and 504 guaranteed loan programs serve a unique role in providing an alternative means for entrepreneurs to access capital where funding is not available through conventional lending methods. Therefore ICBA believes the economic slowdown and greater credit-risk aversion in the credit markets should be fostering a stronger demand for guaranteed SBA loans. Unfortunately, small business SBA loan volume is declining sharply. This is aggravating the economic problems and only validates the importance of ensuring a more robust Small Business Administration with affordable and workable loan programs for a wide range of lenders and borrowers. Thriving small businesses are exactly what is needed to turn this economy around and to boost payroll and business income tax revenue back to federal, state and local government. Small businesses are critical to supporting a tax base.

Like thousands of community banks across our nation, Bank of the West is doing its part to support our local economy with small business lending and is dedicated to the success of small business and the community. Bank of the West has facilitated more than $8 million in SBA loans in our local communities. These SBA loans create hundreds of jobs by financing the local preschool, health center, hardware store, or auto dealer. Bank of the West has dedicated half of our bank facility lobby to a small business center where our customers can come in and get online to place orders or use our conference room to meet with their clients. We work intimately with our small business customers. For example, Bank of the West counseled a local entrepreneur, assisted with a business plan, and facilitated a SBA loan for a small salon. Today, the SBA loan has been paid off and the successful salon employs 20 people.

With small business development one of the fastest growing segments of our changing economy, the demand for small business capital will only increase. The demand for SBA 7(a) and 504 loans will increase as well and it is critical to ensure these programs are best suited for meeting the needs of small business. However, ICBA believes recent changes to the budget and loan programs are causing the SBA to fall far short of its ability to facilitate affordable small business capital.

Disturbing Decline in the Number of Active SBA Lenders

Despite the growing need for small business capital, the SBA loan programs have been harmed by recent policy changes. In recent years, many community banks have found it much harder, not easier, to provide needed capital to small businesses through the SBA loan programs. Notably, the number of lenders that have made at least one SBA 7(a) loan has dropped almost in half from 5,288 in 2001 to less than 2,700 today. This is a disturbing trend.

Also troubling is the fact that many of the large financial institutions that consumed the lion's share of the SBA loan programs are the same banks that are struggling under the sub-prime mess and unable to continue the same level of SBA lending at this critical economic time. The majority of our nation's commercial banks are community banks. The geographic dispersion of community banks around the country fosters a financial system where money and resources are made available not only in large urban areas, but in suburban and rural areas as well. That is why it is perplexing to note that the top 25 SBA lenders eat up two-thirds of the SBA's 7(a) loans with just 10 big lenders making more than 55 percent of the loans. ICBA does not believe Congress intended the SBA loan programs to be functional for only a handful of the nation's biggest financial entities. ICBA urges that SBA programs be allowed to work for as many interested lenders as possible in many geographic areas to best meet the needs of small business borrowers.

During his Congressional confirmation hearings, the new SBA Administrator Steven Preston stated:

> *Ultimately, the SBA must serve its constituents in a way that is responsive to their needs and responsible to taxpayers. If nonparticipation from smaller and community banks in SBA programs results in small businesses not being able to benefit from its programs, it will be critical for me to get to the heart of the issue and address it.*

Community bankers run small businesses themselves, live and work in the communities with their small business customers, and will do everything possible to ensure they can support the credit needs in these more difficult economic times. SBA lending is an important part of this equation. ICBA wants to help identify ways to have more interested lenders be able to successfully leverage the SBA loan programs to serve a wide range of small businesses in as many geographic locations as possible.

SBA Programs have been Hurt in Recent Years

The sharp drop-off in active SBA lenders has been the result of a combination of discouraging factors that has undermined the community banking industry's ability to participate. These damaging changes include sharp SBA budget cuts, the elimination of any appropriations for SBA 7(a) loan programs, increased lender and borrower fees, the elimination of combination or "piggyback" financing, reduced staffing and service from local SBA offices, lower loan guarantee levels, as well as the elimination of popular loan programs such as "Low-Doc."

Chairman Kerry, and Ranking Member Snowe, the ICBA appreciates your strong support for the popular and successful "Low-Doc program. In fact, you wrote to, petitioned, and directly requested the Small Business Administration at your committee hearings not to end the Low-Doc program. You specifically urged the SBA to work with Congress to strengthen the Low-Doc program rather than terminate it. Unfortunately, the SBA unilaterally ended the Low-Doc program and as a result, hundreds of SBA lenders dropped out of making any SBA loans altogether because of lower loan guarantees, higher fees, and greater paperwork burdens.

ICBA sincerely appreciates your leadership and efforts, Chairman Kerry, in holding this important hearing to help get the SBA loan programs back on track at this difficult time for small business borrowers and lenders. We fully support your "Small Business Lending Stimulus Act" legislation (S. 2612) that will lower SBA loan fees similar to the successful policy implemented to help the economy and small businesses post "9-11." We believe this will allow more lenders to facilitate SBA loans so that more small businesses can get the funding they need to be successful and jumpstart economic activity.

Small Business Access to Capital is Key to Economic Growth

As small businesses represent a large and growing share of our economic well-being, the sharp budget cuts the SBA has suffered in recent years have come home to roost in this challenging credit market. We cannot shortchange SBA lending and small business needs without consequences, especially when the economy softens. Small businesses employ more than half of the private sector workforce and produce more than 50 percent of the nonfarm private sector Gross Domestic Product. Small businesses are responsible for two-thirds of all the net new jobs being created. Given the significance of small business growth to our economy, this is no time for the SBA loan programs to be in a sharp decline. The need for affordable small business capital is greater today than ever.

However, we have witnessed sharp SBA budget cuts in recent years. The SBA budget proposed for fiscal year 2009 is a tiny 0.02 percent of the proposed federal budget. In fact, the SBA's non-disaster program budget is about half of what it was in 2001. While there are efficiencies with new technology that can be achieved, when an agency's budget is nearly cut in half, the service and functionality of its programs will suffer. This was most evident in the troubled SBA disaster lending response after the Gulf Coast hurricanes. We don't want to witness a similar fate now in the SBA 7(a) and 504 loan program as loan volumes decline just when credit is needed most. If stimulating our troubled economy and supporting our nation's small businesses is a priority, we urge that more, not less, budget resources be allocated for the SBA and its proven lending programs.

Restore 7(a) Appropriation and Lower Steep Fees

An ongoing major concern of the community banking industry has been the elimination of the long-running appropriation for the SBA 7(a) loan program that was as much as $115 million in FY2001. As a result of the elimination of any appropriation for 7(a), the lender and borrower fees have been increased sharply and continue to increase under the "zero-subsidy" model. With no appropriated money, more and more Small Business Administration costs are being passed on to the lenders and borrowers. When the appropriation was being eliminated with the blessing of the SBA, the SBA officials assured concerned lawmakers, lenders, and small business groups the program would be better off. Today, with declining loan volumes and far fewer SBA lenders, the evidence is clear that this is not the case. Community lenders have been forced to drop out of the program, and a greater concentration of SBA loans have gone to a handful of the nation's biggest banks where many are embroiled in their own capital difficulties and unable to meet the SBA borrowing needs of small business.

With higher fees, many deserving entrepreneurs that were on the margin of obtaining a 7(a) loan are no longer able to afford such financing. This has the effect of shifting the delivery of SBA 7(a) loans further away from the fundamental mission of reaching deserving small businesses in greatest need of inexpensive, guaranteed financing. ICBA believe the decline in the number of SBA lenders and the shrinking of average loan size has left many small businesses with less capital to grow their businesses and create jobs.

For smaller SBA loans, today's higher fees can translate into nearly $1,500 to $3,000 more in upfront closing costs for entrepreneurs. The added costs from today's higher fees can be up to $50,000 for larger small business loans. Higher fees only discourage the very type of small business borrowers the SBA guaranteed loan programs were intended to reach from accessing needed capital during difficult economic times.

The House of Representatives has repeatedly acted to address the higher SBA loan fees by restoring an appropriation for the 7(a) program. On a *bipartisan* basis, the House has successfully passed an appropriation several times to help offset higher fees, only to be thwarted in the final budget for SBA loan programs. The appropriation for 7(a) had the support of some 20 small business groups nationwide and was not opposed by any small business group.

In order to help improve the SBA 7(a) loan program, ICBA again urges Congress to restore an appropriation for the 7(a) loan program. Any appropriation should be applied proportionally to reduce the lender and borrow fees. This will help bring back a greater number of community bank lenders into the SBA loan programs and deliver more SBA loans to deserving small businesses in local communities across America. SBA has claimed the appropriation exposes the SBA program to a shut-down scenario should the appropriation be delayed or not approved. This is not correct. There should be absolutely no reason to shut down the 7(a) loan program as SBA has done in the past due to the timing of any Congressional appropriation. The existing program fees can be set to continue to fund the program and any subsequently appropriation can be applied to adjust these existing fees.

Restore "Low-Doc" Program

With the fallout from slashed SBA budgets, the elimination of any 7(a) appropriation, and higher loan fees to compensate, something had to give. Unfortunately, the popular and successful low documentation or "Low-Doc" program was eliminated in an attempt to contain sharply rising fees under a system without any 7(a) appropriation. Frankly, the name "Low-Doc" may be a misnomer. While the SBA Low-Doc application may be streamlined, bank regulators would strongly criticize the bank if its loans were not adequately and thoroughly documented. Lenders still have to perform due diligence and approve all Low-Doc loan requests prior to the SBA's additional review and approval. So despite the streamlined application, lenders will still require enough data to fulfill their need to thoroughly evaluate a loan request based on their own credit policy.

The Low-Doc program worked extremely well for many small business borrowers and served an important niche for lenders making a small number of SBA 7(a) loans. The Low-Doc program especially enabled small and rural-based lenders to participate in the 7(a) program. Low-Doc worked well for community banks that were not in the Preferred Lender Program (PLP) or Certified Lender Program (CLP) yet had considerable small business lending experience. In many towns served by community banks, where the population may be under 3,000, a small number of SBA Low-Doc loans makes a big difference in the local economy.

Terminating the successful Low-Doc program eliminated an important choice for small businesses seeking affordable capital. The end of Low-Doc further pushed SBA lending into a one-size-fits all program. The SBA Express program, often touted as a substitute for Low-Doc, provides only a 50 percent guarantee versus the Low-Doc's 80 percent guarantee. SBA Express program was pitched as a better fit for borrower needs but is not a viable substitute for Low-Doc. The 50 percent guarantee under an Express loan is often not enough to rely on for a new start-up business to qualify for financing, so in the end, entrepreneurs suffer the fallout. The SBA Express program is down

27.9 % in number of loans and 22.6% in dollars year-over-year as of March 2008. The lesson here is that SBA 7(a) lending should not be allowed to morph into a one-size-fits-all, cookie cutter program that works only for a limited number of big bank lenders and limited small business needs.

The end of the popular Low-Doc program in turn led to the greater concentration of SBA loans in the largest lenders. The top ten lenders account for nearly 60 percent of all SBA loans. ICBA believes the small business borrowers are best served if the loan programs are workable for a broad array of lenders and in many geographic areas across America, both urban and rural. The SBA 7(a) loan program should be allowed to work well for lenders making 10 loans or 10,000 loans.

Reinstate "Piggyback" Financing

The ICBA requests that the successful use of combination ("piggyback") financing be restored as an option for SBA lenders. SBA suspended this valuable lending option in 2004. Piggyback financing provided lenders with greater flexibility in meeting the financing needs of small businesses, especially small businesses in need of greater financing levels.

Once again, adding more flexibility to SBA lending will avoid the one-size-fits-all problem that prevents deserving small businesses from accessing affordable capital. Ironically, this combination loan structure is quite similar to the loan structure provided in the successful SBA 504 program on mortgage lending. Reinstating piggybacking financing will prevent the unfortunate result where many small businesses with larger loan needs are being completely shut out from accessing financing through the 7(a) program.

SBA Needs Staff

The proposed FY 2009 SBA budget falls far short of reversing the dramatic budget cuts the SBA has suffered in recent years. ICBA request that SBA increase agency staffing and increase the number of satellite SBA offices. SBA budget cuts and the elimination of regional offices and staffing are why many lenders have found the SBA program less responsive and more difficult to navigate. Having huge SBA processing offices in Fresno or Sacramento, California may serve the needs of some lenders. However, if SBA programs are to work best, minimize risk and facilitate proper oversight, it is also important that SBA officers be located closer to where lending is taking place to be familiar with local business conditions.

ICBA recommends that additional budget staffing resources be allocated in part to assisting the thousands of non-PLP lenders serving small business needs. This can help reverse the decline in SBA participating lenders and help meet the needs of many more businesses seeking SBA funding nationwide.

Conclusion

America's small businesses are facing difficult economic times and accessing needed credit is getting more problematic. As policymakers work on ways to stimulate the economy and strengthen credit markets, small business credit needs and SBA lending should be front and center in the debate. Given the importance of small businesses for job creation and economic strength, the plummeting levels of SBA lending is cause for alarm. Community banks like Bank of the West are well-positioned and prepared to help. However, lenders and borrowers need the SBA programs fees to be reasonable. The ICBA pledges to work with the Small Business Committee to ensure our Nation's small businesses have the access to capital and credit they need to invest, grow, and to provide jobs and continued economic growth. ICBA will continue to urge Congress and the Administration to adequately fund the Small Business Administration and the successful 7(a) and 504 loan programs.

Today's changing economic environment is a time to strengthen small business resources and build upon the successful SBA loan programs. Providing needed capital resources to small businesses through broad community bank participation in SBA lending will help strengthen economic growth and foster greater job creation. ICBA sincerely appreciates the opportunity to testify today on the important issue of available small business capital and lending. Thank you.

Senator SNOWE. Thank you very much. That is very constructive testimony.

Mr. O'Connell.

STATEMENT OF DANIEL O'CONNELL, SECRETARY, EXECUTIVE OFFICE OF HOUSING AND ECONOMIC DEVELOPMENT, BOSTON, MASSACHUSETTS

Mr. O'CONNELL. Good afternoon, Chairman Kerry and Ranking Member Snowe. My name is Dan O'Connell. I serve as Secretary of Housing and Economic Development for the Commonwealth of Massachusetts. The Secretariat oversees the Departments of Business Development, Housing and Community Development, and Consumer Affairs and Business Regulation.

I commend you for scheduling this timely hearing to discuss the impact of the disruption of the credit markets on small business financing. The importance of small business to the national economy is well known. Small businesses continue to play a key role in the Commonwealth's economy, as well.

As of September of 2004, there were over 200,000 small businesses in Massachusetts employing over 2.4 million people. Our smallest businesses, those employing 20 individuals or less, employ 28 percent of our total workforce in the State. The continued emergence of new small business as well as the healthy growth of existing business is critical to our economy and is a significant source of new jobs.

Small businesses are feeling the effects of the credit crunch. The Massachusetts Business Development Corporation, which works closely with our Secretariat, informs us that small business loans that they have closed in the first three months of this year are up from $1,750,000 a year ago to $6,125,000 for the same period this year. Small businesses typically turn to the Business Development Corporation when bank loans are not available, so this increase is direct evidence of the tightening of bank credit.

BDC's Massachusetts Small Business Capital Access loan guarantees are also up 12 percent from a year ago, offering further evidence that banks are requiring credit enhancement before agreeing to grant credit to many small businesses.

As I have traveled around the State of Massachusetts from Holyoke to Lawrence to Fall River in the last month, I have been meeting with small business groups and community bankers. The story is the same throughout the State. The balance sheets of the community banks are relatively healthy. They didn't get drawn into the subprime lending business as much as some of the larger banks and financial institutions did. But there is a crisis of confidence. They don't know where the bottom is. They don't know where the pricing is. And so they are hesitant to make loans to long-term customers, and those customers are suffering because of this.

The Massachusetts Association of Community Development Corporations, which we regularly partner with and are the key source of micro loans in the Commonwealth of Massachusetts, are seeing an increase in applications for owners who would have typically tapped the equity in their homes, either through a refinancing or through a home equity line. These credit sources do not seem to be available in the same way they were even a year ago.

The Massachusetts Small Business Development Center Network reports that lenders are pressing their clients, small business owners and entrepreneurs, for greater cash reserves or collateral for their loans, shorter repayment periods, and more cautious estimates of projected revenue when evaluating loan applications. All of these trends have picked up in the past one to three months as the national economy has slowed.

At the State level, the Commonwealth of Massachusetts has two significant programs designed to address credit needs of small business. The Massachusetts Small Business Capital Access Program has been very active and is currently working with over 100 banks. The Massachusetts legislature recently gave approval to recapitalize our CAP program with $5 million in additional funds.

We also have a program called the Massachusetts Banking Partners Small Business Loan Program. This partnership program is run by our mainly local and community banks and provides credits to them for their Community Reinvestment Act efforts. That program is focused on the needs of very small businesses located in low- and moderate-income census tracts.

Despite these efforts, and perhaps more than ever before, the SBA loan and Technical Assistance Program are essential to the success of small business across America. The legislation that has been proposed by this committee reducing fees, increasing funding for micro loans, and making availability of refinancing of debt at lower rates, are very important and critical to the health of small business.

Again, thank you for calling today's hearing. As we continue to work our way through our current economic difficulties, small businesses will continue to face increasing credit challenges. It is these small businesses that can play a significant role in our economic recovery by adding new and sustainable jobs. Thank you.

[The prepared statement of Mr. O'Connell follows:]

TESTIMONY OF

DANIEL O'CONNELL

SECRETARY

FOR THE EXECUTIVE OFFICE OF HOUSING AND ECONOMIC DEVELOPMENT

COMMONWEALTH OF MASSACHUSETTS

On

THE IMPACT OF THE CREDIT CRUNCH ON SMALL BUSINESS

Before the

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

UNITED STATES SENATE

April 16, 2008, 2:30 p.m.

Room 428A, Russell Senate Office Building

Introduction

Good afternoon, Chairman Kerry, Ranking Member Snowe, and other distinguished members of the Committee. My name is Daniel O'Connell and I serve as the Secretary for the Executive Office of Housing and Economic Development for the Commonwealth of Massachusetts. My office oversees the Departments of Business Development, Housing and Community Development, and Consumer Affairs and Business Regulation...

While the Massachusetts economy continues to fare better than many states, the Commonwealth has not been immune from the slowdown in our nation's economy. A week ago today, Governor Deval Patrick joined the leaders of the Massachusetts State Legislature at the MIT Sloan School of Management and unveiled a blueprint for an economic plan based on restrained government spending and long- and short-term investments. Governor Patrick's message was fairly simple. He noted that "state government has its limitations, but it has its responsibilities as well. Government alone cannot create new jobs, but we create conditions that foster a culture of opportunity that helps secure the state's short-term fiscal health and guarantees our long-term economic prosperity." I bring his message here today. The federal government and state governments have limited resources, but we can work together to foster investment in our communities and our small businesses. This will ensure the strength of both our local and national economies and the availability and growth of great jobs at competitive wages.

I commend you, Mr. Chairman, for scheduling this timely hearing to discuss the impact of the disruption in the credit markets on small business financing. The success of small businesses is paramount to the United States' and our local economies. According to the United States Small Business Administration ("SBA"), there were an estimated 25.8 million small businesses in the United States in the year 2004.[1] These small businesses created 60 to 80 percent of the new jobs in the last 10 years and employ over 50 percent of the nation's private sector workforce.

Small businesses continue to play an instrumental role in the Commonwealth's economy as well. As of September 2004, there were over 200,000 small businesses in Massachusetts employing over 2.4 million people. Our smallest businesses, those employing 20 individuals or less, employ 25 percent of the Massachusetts workforce. The continued emergence of new small businesses as well as the healthy growth of existing small businesses is critical to our economy and is also a significant source of new jobs.

We have already witnessed tremendous upheaval in the mortgage and student loan industries. As a result, mortgage and student loan underwriting criteria have significantly tightened resulting in a noteworthy reduction in credit availability. The tightening of these markets will ultimately retard the recovery of the housing sector and further challenge parents and students already faced with increasing costs and now the realistic probability of fewer college financing options.

The disruption in the credit markets has not impacted the availability of small business loans to the same extent as mortgage loans and student loans. However, small businesses are feeling the effects of the credit crunch. The Massachusetts Business Development Corporation, which works closely with the Massachusetts Office of Business Development, tells us that small business loans that they have closed in the first three

[1] The United States Small Business Administration's Office for Advocacy defines a small business as a firm with fewer than 500 employees.

months of this year are up from $1,750,000 a year ago to $6,125,000 for the same period this year. Small businesses typically turn to the BDC when bank loans are not available so this increase is direct evidence of the tightening of bank credit. BDC's Massachusetts Small Business Capital Access loan guarantees are also up 12% from a year ago, offering further evidence that the banks require further credit enhancement before agreeing to grant credit to many small businesses.

The Massachusetts Association of Community Development Corporations has told us that they are seeing an increase in small business loan applications from business-owners who would have typically tapped into the equity of their homes, either through a cash-out refinancing or through a home equity line of credit. The Massachusetts Small Business Development Center Network also tell us that lenders are pressing their clients – small business-owners and entrepreneurs – for greater cash or collateral for their loans, shorter repayment periods and more cautious estimates of projected revenue when evaluating their loan applications. All of these trends have picked up in the past one to three months, as the national economy has slowed.

Any significant curtailing of small business credit will have a devastating impact on our overall economic recovery. Restrictions in financing could result in small businesses needing to increasingly rely on more expensive credit card financing, savings, or borrowing from family and friends. This would significantly increase operating costs and curtail expansion opportunities.

Massachusetts Innovations to Support the Financing of Small Business

Access to credit and other banking services remain paramount to the success of small businesses. Massachusetts banks have historically played a significant and vital role in providing such financial services to numerous small businesses located throughout their communities. Nevertheless, it is estimated that nearly 10 percent of the nation's population at this time remains unbanked. Accordingly, many of our smallest and emerging new businesses are likely to be owned and operated by individuals that are indeed unbanked.

Individuals without traditional banking relationships are predominately low income and minorities. As a result of being outside the financial mainstream, unbanked individuals are typically dependent upon non-traditional, more expensive providers of both credit and other money management services. In the case of small businesses, the reliance on these higher cost financial services directly impacts profitability and prospects for growth. Massachusetts has developed two programs designed to make financing easier for our smallest businesses.

Massachusetts Small Business Capital Access Program ("CAP Program")

In the early 1990s, Massachusetts was also facing a credit crunch. The ongoing recession and the New England banking crisis resulted in a substantial reduction in credit availability especially for small and new businesses. Recognizing that most new jobs are created by small businesses and that the creation of new jobs would be vital to the Commonwealth's ability to emerge from the economic downturn which was especially challenging the Northeastern United States, Massachusetts policymakers sought new innovative solutions to encourage increased small business lending. The result was the highly successful Massachusetts Small Business Capital Access Program, or CAP Program.

In an effort to encourage bank lending, $5 million in state funding was initially appropriated to provide a cash collateral guarantee or credit enhancement to small business loans made under the CAP Program. This allowed banks to originate loans they might not otherwise have been able to make.

Today, over 100 banks participate in the CAP Program. Since banks utilize their own underwriting criteria and directly provide the funding, the loans are simpler to originate than loans made through the SBA. Banks also receive credit under the Massachusetts Community Reinvestment Act for participating in the CAP Program.

The CAP Program is designed to assist small businesses with annual revenues of $5 million or less to obtain financing from participating banks. CAP Program loans may be used to start or expand businesses, or to provide permanent working capital to ensure continued profitable operations. Typical uses are equipment purchases, start-up costs, and real estate acquisitions. The CAP Program can also be used for working capital lines of credit.

In 15 years, a total of $10 million in state funding has been leveraged into $241 million in loans to 3,828 small businesses. With an average loan amount of $51,000 and loans as small as $1,000, CAP Program loans have helped create or retain 26,000 Massachusetts jobs and brought in over $100 million in payroll taxes to the Commonwealth. The CAP Program has also been instrumental in providing financing to small businesses in inner city neighborhoods with more than $20 million in loans to 275 businesses in Boston, Roxbury, and Dorchester. Finally, $34 million in CAP Program loans have gone to start up businesses. An additional $22 million in loans have been provided to firms with annual revenues of less than $100,000.

Massachusetts Banking Partners Small Business Loan Program ("Banking Partners")

The charge of the Massachusetts Banking Partners Small Business Loan Program, or Banking Partners program is also to provide greater access to reasonably priced credit and banking services to small businesses as well as access to vital business assistance services. The program recognizes that many start-up and small business owners need help with recordkeeping, general management, and in preparing a business plan and financial statements. Specifically intended for very small businesses located in low- or moderate-income census tracts needing small dollar loans, the Banking Partners Program matches small business owners receiving technical assistance and training from small business assistance providers with participating banks.

These participating banks accept referrals of small business applicants who are receiving services from not-for-profit small business assistance providers. In exchange, participating banks offer small business loans at a rate below the lender's typical market rate; make smaller dollar loans than those generally available; and consider financing for early-stage businesses. Banks participating in the Banking Partners program all receive consideration under the Massachusetts Community Reinvestment Act.

United States Small Business Administration Loan Programs

For over 50 years, the SBA has been an important tool in providing access to capital for small businesses. As a guarantor of loans, the SBA helps reduce the risk to banks and other financial institutions. The SBA offers several loan programs to help small businesses including its Section 7(a) Loan Guaranty Program, the Section 504 (Certified Development Company, or CDC) Loan Program, and the Microloan Program.

7(a) Loan Guaranty Program

The Section 7(a) Loan Guaranty Program helps qualified existing and start-up small businesses obtain working capital financing when they might not qualify for standard business loans. It also offers the flexibility to guaranty loans for a variety of general business purposes, including fixed assets such as equipment, furniture and fixtures; land and buildings (including purchase, renovation and new construction); leasehold improvements; and, in limited circumstances, debt refinancing. Because the program acts as a guaranty, banks and other lending institutions are under no obligation to lend. Banks make their own lending decisions based on their own lending criteria. If a small business does not qualify for a business loan using its standard underwriting criteria, the bank can apply to use the 7(a) program to guaranty a portion of the loan in the event of a default by the borrower. The bank therefore shares the risk with the SBA to ensure that prudent underwriting is always used.

Section 504 (Certified Development Company (CDC)) Loan Program

The Section 504 Loan Program provides long-term, fixed-rate financing to existing small businesses to acquire real estate or other fixed assets for expansion or modernization. Rather than a bank making the entire loan with a guaranty (like the 7(a) program), a lender would typically make a secured loan for up to 50% of the project's cost. A Certified Development Corporation (or CDC, a private, non-profit corporation established for the purposes of local economic development) would make a junior lien loan for up to 40 percent of the cost (funded by a 100 percent SBA-guaranteed debenture). The borrower would be expected to contribute at least 10 percent in equity. By layering risk across several levels, including the business owner, the lending bank has a greater incentive to lend to small businesses and can leverage Section 504 CDC loans to increase its total lending ability.

In Massachusetts, the New England Certified Development Corporation (formerly known as MassCertified) administers the Section 504 program to small businesses across New England. New England Certified makes loans, or debentures, from $500,000 to $2 million ($4 million for manufacturing industries). New England Certified is one of only 16 "premier" certified sites in the United States.

Microloan Loan Program

The Microloan Program provides important short-term loans of up to $35,000 to small businesses and not-for-profit child-care centers for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. Microloans can not be used to refinance debts or to purchase real estate. The SBA does not guaranty these loans to the small businesses; rather, the SBA guarantees a loan to a nonprofit intermediary with experience in lending and technical assistance. The intermediary then makes the microloan to the applicant small business.

Strengthening the SBA and Improving Small Business Access to Capital

The disruption in the credit markets has not impacted the availability of small business loans to the same extent as mortgage loans and student loans. However, small businesses are feeling the effects of the credit crunch. Certainly tighter credit standards and declining home values have made it harder for many small businesses and start-ups to tap into the equity of their homes, either through a cash-out refinancing or through a home equity line of credit. Small business people are risk takers and often rely on their home's values to finance their businesses. However, for many small business men and women, tapping into a home's equity may not currently be an option.

In addition, credit standards have tightened for both commercial real estate and business loans. A Federal Reserve survey of bank loan officers confirms that over 80% of banks have tightened lending standards for commercial real estate loans. Without access to capital, small businesses, which account for the majority of all job growth, are unable to invest in new equipment, acquire new office or manufacturing space, or, ultimately, hire new personnel.

Perhaps more than ever before, the SBA loan and technical assistance programs are essential to the success of small businesses across America. Fortunately, two pieces of proposed legislation would enhance the SBA's lending programs and increase access to its programs by small businesses. The "Small Business Stimulus Act of 2008" (S.2553) would, among other things, reduce the fees paid by both lenders and borrowers under the 7(a) loan program by appropriating a $150 million offset. In addition, S.2553 would provide an additional $2 million in funding for the SBA Microloan Program.

Like S.2553, "The Small Business Lending Stimulus Act of 2008" (S. 2612) would reduce fees under the 7(a) program and provide additional funding for the Microloan Program. In addition, S. 2612 would also enhance the 504 Loan Program with a $45 million appropriation to offset a reduction in fees charged to borrowers and intermediaries. Finally, S.2612 would allow for an expansion in the ability of small businesses to refinance debt to reduce their costs. This is an important benefit as small businesses are faced with higher levels of debt and unable to refinance to a lower interest rate under the traditional SBA loan programs.

Conclusion

Again, Mr. Chairman I thank you for calling today's hearing. As we continue to work our way through our current economic difficulties, small businesses will also face increasing challenges. It is these small businesses, however, that can play a significant role in our economic recovery by adding new and sustainable jobs. I appreciate and endorse your efforts to enhance SBA lending programs. But the federal government can not do it alone. Innovative collaborations between state governments, non-profit entities, and local banks as I have described have also proven to be extremely effective in nurturing and supporting our small businesses and creating new and long lasting jobs. I thank you for the opportunity to testify and would be happy to answer any of the Committee's questions.

Chairman KERRY [presiding]. Thank you very much, Mr. Secretary. I appreciate it.

Mr. Mitchell.

STATEMENT OF ROBERT L. MITCHELL, FOUNDER AND CHIEF EXECUTIVE OFFICER, MITCHELL AND BEST HOMEBUILDERS LLC, ROCKVILLE, MARYLAND

Mr. MITCHELL. Thank you, Chairman Kerry, Ranking Member Snowe, and members of the committee. My name is Bob Mitchell. I am Chairman and CEO of Mitchell and Best Homebuilders, a 33-year-old home building firm located in Rockville, Maryland, and a past President of the National Association of Home Builders, NAHB. Thank you for the opportunity to be here today to talk about the impacts of the credit crunch on the small home builder businesses and potential solutions for the Congress to consider.

A pricing-induced housing downturn that began in 2005 has been exacerbated by the credit crunch that started in mid-2007. This will continue to be the most significant factor affecting the home building industry into the foreseeable future. That means depressed home prices, more deterioration in mortgage credit quality, sharply reduced credit availability, and much tighter credit standards for those who can still qualify.

Home builders all over the country are experiencing a negative shift in terms of availability on loans for land acquisition, land development, and home construction, commonly known as AD&C loans. In addition, builders with outstanding AD&C loans are facing additional challenges as lenders receive appraisals reflecting lower values on lots and homes. Lenders are asking builders to fully or partially pay down the outstanding loans while in extreme cases denying requests for loan extensions. Most small home building companies don't have the resources to survive in such an environment for any extended period of time.

Let me share a few observations from my own personal experience in this area. Home building requires a longer planning and approval process. The cycle is much longer than in most other industries. That means we are investing in today for tomorrow.

There is currently a dislocation in the housing market where entry-level home buyers cannot access mortgage credit to purchase a home. In turn, home owners higher up the ladder cannot sell their current home. I call it the food chain of housing. They cannot sell their current home in order to make their next home purchase. Thus, the credit crunch shuts down the normal progression of home selling and home buying that we experienced in America.

When the credit markets break down in the midst of a housing dislocation, home builder investment is extremely difficult to maintain. For me and for many home builders, the housing downturn, as I said, began two years ago and the credit crunch we are now experiencing is a significant additional problem. I have exhausted my company's resources and am now forced to take more extreme measures to keep afloat. For example, I have laid off 40 percent of my employees and tapped my personal assets to maintain solvency. My lenders are being as flexible as they can. However, if the housing market does not stabilize soon, they and I will eventually run out of options.

Avoiding excess regulatory restrictions on federally insured banks, which are currently the predominant source for our AD&C loans, is an urgent priority. However, the difficulty of builders in obtaining housing production financing during this time also vividly highlights the need to develop additional sources of AD&C credit. My written statement includes a number of specific recommendations for increasing the range of suppliers of housing production credit.

The Senate has taken several steps to ease the financial losses that home builders like many small businesses are facing during this economic downturn. I cannot overstate how important it is for business owners to have the ability to claim and carry back net operating losses deductions to years when significant taxes were being paid. NAHB applauds the Senate for approving a temporary expansion of the NOL carry-back period as a part of the Foreclosure Prevention Act of 2008, and I would especially like to thank Senators Snowe and Kerry for their leadership on advancing an expanded NOL carry-back.

As Congress continues to look for additional ways to ease the credit crunch on small businesses, they should consider policies that stimulate home purchases in the immediate future. A temporary home tax credit would reduce excess inventory and relieve pressure on falling home prices by ending the waiting strategy of some potential buyers who are taken out of the market. An effective home buyer tax credit would restore confidence in the housing market for home owners, home buyers, and financial institutions, mitigating some of the factors responsible for the current credit crunch.

NAHB appreciates, and I do, also, the efforts by Congress to address the problems related to small businesses and the credit crunch and we look forward to working with legislators on the most effective way to help America's small businesses during this time.

Again, thank you for the opportunity to testify today, Senators.

[The prepared statement of Mr. Mitchell follows:]

Testimony of

Robert Mitchell

On Behalf of:

The National Association of Home Builders

To The

United States Senate
Small Business Committee

Hearing On

"Impacts of the Credit Crunch on Small Firms"

April 16, 2008

Introduction

On behalf of the almost 250,000 members of the National Association of Home Builders (NAHB), we appreciate the opportunity to participate in this Senate Small Business Committee hearing on "Impacts of the Credit Crunch on Small Firms." My name is Bob Mitchell and I am a home builder from Rockville, MD. I served as President of the National Association of Home Builders in 2000, and have been involved in the home building industry for over 35 years.

The majority of NAHB's builder members are small businesses, building less than 25 homes per year. These builders typically get their financing from depository institutions. Many borrow from small, community-based banks and thrifts and have established strong ties to these institutions over time. NAHB's members have been significantly impacted by the credit crunch and there is deep concern that the dislocations in the financing markets will increase the depth and length of the housing downturn.

Housing Credit Market Conditions

The mortgage credit crunch, which began in the summer of 2007, will continue to be the most significant factor impacting the home building industry into the foreseeable future. The U.S. housing market now is in the contraction phase of the most pronounced housing cycle since the Great Depression. This dramatic contraction has exacted a heavy toll on economic growth and employment during the past two years, and now has pushed the U.S. economy into recession according to NAHB macroeconomic analysis.

The adverse economic impacts of the housing contraction involve not only sharp declines in home sales and housing production, but also depressing effects of falling home prices on household wealth and mortgage credit quality. These events have provoked an alarming surge in mortgage foreclosures that have cut into the homeownership rate. Further, events have seriously damaged financial institutions holding mortgage assets, as well as companies that provide mortgage credit enhancement.

The pronounced decline in mortgage credit quality first became evident in the subprime mortgage sector last year, and that debacle triggered a stampede toward credit quality in national and global credit markets. This process has essentially shut down or seriously damaged a wide range of securities markets, including major components of the mortgage securities markets in the U.S. The freezing-up of private securities markets, both here and abroad, has shifted credit demands to government-related securities markets and to depository institutions – resulting in higher loan volume and pressures on capital positions at the depositories. The banking system, in turn, has been aggressively tightening lending standards in order to control volume, maintain asset quality and shepherd capital.

With private securities markets in disarray and banks retrenching, a bona fide credit crunch is underway. This credit crunch actually appears to be worsening despite the concerted efforts of central banks here and abroad. The Federal Reserve has been easing monetary policy aggressively since last fall, and probably will do more in the near future. These actions have improved the functioning of short-term money markets, including the interbank markets, but the Fed has not been able to relieve strains in longer-term credit markets.

With the deterioration of housing demand, exacerbated by the credit crisis and the fear and uncertainty concerning future housing price declines, for-sale housing market inventories are at historic levels. For example, the new homes inventory stands at a 9.8 months supply. The record volume of vacant homes on the for-sale market inevitably will put persistent downward pressure on home prices for some time. These interrelated factors of inventories and home price decline are central to the outlook for the economy and the financial markets.

Continued downward pressure on home prices also further saps the quality of outstanding mortgage credit, making it even more difficult to refinance or restructure adjustable-rate mortgages that have encountered or are facing payment resets. These effects, in turn, will worsen the alarming upsurge in mortgage foreclosures; move even more homes onto the for-sale market, put even more downward pressure on house prices and mortgage quality; and stretch out the contraction in new housing production even further. This represents quite a feedback loop, with ominous potential consequences for the U.S. economy and the financial markets.

Housing Production Credit

The tightening of credit standards and sharp reduction in credit availability that emerged and spread in the consumer mortgage arena has leapt to the housing production loan market. Builders are reporting an adverse shift in terms and availability on loans for land acquisition, land development and home construction (AD&C) and builders with outstanding loans are facing mounting challenges. Lenders are receiving current appraisals reflecting lower values on lots and homes, as well as market studies significantly scaling back absorption estimates. As a result, lenders are seeking additional equity for outstanding credits and balking at loan extensions. Defaults on AD&C loans are rising. The bank regulators have raised concerns about real estate lending and are reviewing the methodology utilized by banks in determining loan loss reserves and levels of delinquent and non-accrual loans for AD&C commitments. In this environment, banks are actively reducing exposure levels to home building credit.

Market Conditions

Residential AD&C loans are used to purchase land; develop lots; build a project's infrastructure such as streets, curbs, sidewalks, lighting, and sewer and utility connections; and construct homes. The vast majority of residential AD&C loans are made by depository institutions. NAHB's surveys of home builder and developer financing found that commercial banks and thrifts account for more than 90 percent of residential land acquisition, development and construction (AD&C) lending, and that commercial banks alone account for more than 80 percent of such activity.

Loans extended to builder/developers are short-term obligations lent as progress payments, i.e., portions of the loan commitment are advanced as stages of the construction project are completed. The advances, or draws, are generally made over a 6-to-18 month period. The principal and interest on the loans is repaid to the lender when the home is sold. Builders typically secure this financing through personal guarantees and/or offering other assets as collateral.

The deterioration in the mortgage credit markets and in home sales and inventories is spilling over into the markets for AD&C loans. Data from the OTS' Thrift Financial Report shows a marked increase in charge-offs on one-to four-family residential construction loans in 2007, as charge-offs as a percent of average loan balance jumped from 23 basis points in the first quarter to 170 basis points in the fourth quarter. For all of 2007, the average charge-off rate was 82 basis points, the highest since 1991 during the last credit crunch.

Bank Call Report data reflect a similar trend at commercial banks. Non-current rates on residential construction loans rose sharply in the fourth quarter, hitting 4.11 percent, which is an increase of 76 percent from the third quarter and 142 percent from the first quarter. (Unfortunately, prior comparisons are not available since banks just started reporting disaggregated residential and non-residential construction loan data in March 2007.)

Regulatory Perspective

These trends have caught the attention of banking regulators who over the past year have been raising concerns about large concentrations of commercial real estate (CRE) loans, which include residential AD&C loans. In particular, regulators are focusing on problems arising from significant community bank concentrations in CRE at a time of significant market disruptions and the declining quality of these loans, especially those related to residential construction and development.

Financial institutions have been reminded to adhere to the December 2006 CRE Exposure Guidance on understanding and managing CRE risks. While this guidance does not include specific limits on CRE lending, it does emphasize that banks with higher CRE concentrations have higher levels of risk and therefore must have risk management and capital commensurate with the higher level of risk. Consistent with this guidance, regulators have stated that in stressed markets, institutions will likely need to downgrade assets, increase loan-loss provisions, conduct fresh appraisals, and reassess the adequacy of bank capital.

The FDIC issued a Financial Institution Letter (FIL) on March 17 which re-emphasized the importance of strong capital and loan loss allowance levels and robust credit risk management for institutions with high CRE exposure. The letter stressed that institutions should follow the 2006 CRE Exposure Guidance. Importantly, the letter also encouraged institutions to continue to make CRE and construction and development loans in their communities using prudent and strong underwriting standards and loan administration practices.

At present, regulators are addressing these concerns through increased bank examinations and forcing some lenders to bolster reserves. Unlike the last credit crunch, when there was wholesale ban on CRE lending, regulators are working with lenders through the supervisory process to address CRE problems early. Nevertheless, the heightened regulatory scrutiny is having an impact on borrowers. Some builders are rapidly drawing down interest reserves and many have had to put up additional equity as appraised values have declined.

Impact on Builders

The upheaval in the housing credit markets has had a significant impact on NAHB's builder members. Tighter mortgage lending terms have made it difficult for home buyers to obtain financing to purchase new homes. Likewise, stricter credit standards for AD&C loans have adversely impacted the cost and availability of builder financing.

Tighter Mortgage Lending Standards

In a national survey conducted this month by NAHB, 64 percent of builders reported that more restrictive mortgage lending standards have adversely impacted their sales. By comparison, in April 2007, only 45 percent of builders were noting sales problems due to financing stresses. In terms of the degree of impact on sales, builders citing buyer financing troubles reported an average sales decline of 15 percent. A third of the builders reported sales declines of 10 to 24 percent, 30 percent said their sales were down 25 to 49 percent, and 31 percent experienced a drop in sales of more than 50 percent.

The constriction in mortgage credit also has contributed to sales cancellations. Overall, 33 percent of the builders surveyed in December said they had contracts cancelled because buyers were unable to qualify for a mortgage. This was up from 28 percent in March 2007. Regarding the scale of cancellations, 44 percent of the builders surveyed said their sales pipeline shrunk by 10 to 24 percent.

Builders have used a variety of techniques to bolster sales and/or limit cancellations, including price reductions, no-cost options or upgrades and financing incentives. The two most widely used incentives are including optional items at no-cost and reducing home prices. NAHB's March builder survey found that 56 percent of respondents had included no-cost options, while 49 percent had reduced prices from the preceding month, with an average price reduction of 3.7 percent. Price reductions as a sales incentive seem to have peaked last fall when 59 percent of builders surveyed in October reported lowering their prices. This in part reflects the waning effectiveness of price reductions, as only 55 percent of respondents rated these as somewhat or very effective in the March 2008 survey, compared to 67 percent in the June 2007 survey. By comparison, 73 percent of the respondents to the March 2008 survey rated no-cost options as somewhat or very effective.

Availability of Housing Production Credit

Weakening AD&C loan performance and stricter regulation has translated into tighter AD&C credit availability and underwriting terms. NAHB's builder financing survey for the fourth quarter of 2007 shows that thirty-five percent of respondents stated that the availability of credit worsened in the fourth quarter relative to the third for single family construction loans. This continued a progressive rise over the past year in the proportion making such an assessment. Thirty-six percent of those seeking land acquisition loans reported worse credit availability; this reading was 30 percent for those seeking land development credit and 24 percent for those trying to line up construction funds for multifamily housing. Of those reporting deterioration of credit availability, 81 percent noted lower loan-to-value limits and approximately two-thirds said lenders are reducing the amount they are willing to lend.

NAHB's April builder survey shows continued tightening in the availability of AD&C credit. Thirty-three percent of respondents reported that the availability of credit for single family construction loans worsened in the first quarter of 2008, compared to the final quarter of 2007. Similarly, 30 percent of those seeking land acquisition loans reported worse credit availability; this reading was 29 percent for those seeking land development credit and 21 percent for those trying to line up construction funds for multifamily housing.

In addition to stricter standards for new AD&C loans, lenders also are tightening requirements for outstanding loans. Roughly a third of respondents to NAHB's April survey reported that lenders had reappraised some or most of their single family construction loans. Three-quarters of those with reappraisals were asked to pay down the original amount, and 13 percent had to put down additional assets. For land acquisition loans, 26 percent of respondents were asked to pay down part of the loan due to possible declines in the value of the land.

NAHB Recommendations

Broader Sources of AD&C Credit

The current financing quagmire for home builders vividly illustrates the importance of developing additional sources of AD&C credit. Presently, funding for viable residential development and construction projects is severely limited or blocked entirely by credit, concentration, capital and other regulatory restrictions on federally insured depository institutions, which are the sole source of housing production credit for the small businesses that comprise most of the home building industry. Furthermore, there is no secondary market for residential AD&C loans where community banks and thrifts could turn to help manage their balance sheets and obtain liquidity for additional lending.

A viable secondary market for AD&C loans would directly benefit builders and lenders by: (1) transferring risk away from lenders; (2) increasing availability of funds so that projects can be more reliably completed; and (3) mitigating the devastating impact of equity calls on builders, or transfers of partially completed projects to banks under capital and/or regulatory pressure.

Government Sponsored Enterprises

One potential source of relief is through a program Fannie Mae has developed to purchase participation interests in AD&C loans made by banks and other qualified lenders. This program was tested successfully for more than a decade as a pilot and has been cleared for permanent operation by the Office of Federal Housing Enterprise Oversight and the Department of Housing and Urban Development. The program was designed as an outlet for banks to sell originated AD&C loans so these institutions could recycle funds into other viable AD&C projects, much like the workings of the very liquid and successful Agency mortgage-backed securities market. Fannie Mae, which has moved very cautiously in launching the permanent AD&C loan purchase program, should be encouraged to ramp up to higher activity levels to provide a much-needed outlet for portfolio AD&C lenders. In addition, Freddie Mac should seek approval to operate a similar program.

The Federal Home Loan Banks (FHLBanks) can also provide support to the AD&C loan market. Over the longer-term they could develop loan purchase programs to support housing production lending efforts in their districts. Immediately, however, the FHLBanks can improve AD&C liquidity by accepting housing production loans as collateral for the secured advances they make to member institutions. Currently these loans are secured mainly by the home mortgage portfolios of borrowing banks and thrifts, and advance activity has risen dramatically as these portfolio lenders sought liquidity support amidst credit market turmoil. The FHLBank of Des Moines received approval from the Federal Housing Finance Board on September 10, 2007 to accept one-to-four family construction loans as part of a basket of other real estate collateral that may back the Bank's advances to member financial institutions in its district. This step will improve balance sheet flexibility for members of the Des Moines FHLBank and improve stability in the region's housing production credit market. Other FHLBanks should be encouraged to follow suit.

Federal Housing Administration

NAHB also believes the Federal Housing Administration (FHA) should play a role in supporting the AD&C credit market. FHA insurance would help increase competition in the AD&C market by attracting new originators such as mortgage banking companies. In addition, FHA-insured construction loans could be packaged in Ginnie Mae-guaranteed securities to allow capital to flow from investors in that market. These benefits would translate into improved credit availability for home builders and home buyers and reduced home buying costs.

FHA already has authority to insure permanent mortgages that are converted from construction loans in construction-to-permanent mortgage programs, which have been growing in popularity. NAHB has obtained a legal opinion that confirms that FHA also has authority currently to insure the construction portion of these loans. NAHB has urged FHA to utilize this authority and we have developed legislative language that would provide FHA the additional authority of insuring stand-alone construction loans. As in the case of the end-loan mortgage market, FHA could be a crucial stabilizing force in AD&C lending in turbulent times such as these.

Privately Issued AD&C Securities

NAHB is also pursuing initiatives with key capital market players to develop a prototype private security instrument for AD&C loans. Discussions have included major financial institutions, including several insurance companies, and we are broadening our search to include other Wall Street specialists. NAHB is pursuing several of the tax changes recommended by the New York State Bar Association to facilitate development of securities backed by AD&C loans. In particular, recommended changes to tax provisions relating to REMICs and Taxable Mortgage Pools (TMPs) could be helpful in securitizing construction loans. NAHB also has met with Congressional staff and members on AD&C tax issues and is seeking legislative vehicles to obtain changes to the REMIC and TMP rules that would facilitate securitized pools of AD&C loans.

Balanced Regulation

The approach of the regulators in overseeing institutions involved in AD&C lending will be an important factor determining the length and severity of the current housing and economic recession as well as the vigor of the subsequent recovery. It is crucial for the banking regulators to take a balanced approach when evaluating bank lending, especially in regard to AD&C loans. The regulators should continue to encourage institutions to pursue sound loans on viable projects. In addition, the regulators should provide additional guidance to lenders on dealing with outstanding AD&C loans to ensure that losses are minimized through flexible and prudent loan accommodations. Such actions are just as critical in a nascent recovery as in the current downswing.

While we recognize the importance of the safety and soundness of the banking system, NAHB urges banking regulators to exercise extreme care in order not to produce unnecessary restrictions on credit. Overly pessimistic assumptions about future home sales and values will result in an unnecessary extension of the credit crunch and housing recession. Draconian restrictions on lending or forced reductions in AD&C concentrations will only serve to exacerbate the present crisis and delay, or even prevent, future recovery. Small businesses, including small builders, are vital to the economy and arbitrary or unreasonable regulatory restrictions would only serve to harm many builders, and potentially many banks. It would be ironic and tragic to have the positive work of the

Fed undone by bank regulators taking a totally different vision and approach when it comes to lending matters.

Federal Home Loan Bank Guarantees of Municipal Bonds

A lesser discussed aspect of the credit crunch is the increasing difficulties experienced by local governments in funding infrastructure projects such as water treatment facilities. Impediments to such financing often have blocked residential development and have sometimes resulted in additional charges being imposed on home builders to pay for improvements that benefit existing residents as well as residents of newly built homes. The financial strength of the Federal Home Loan Banks (FHLBanks) allows them to provide stand-by letters of credit to facilitate municipal bond issues for infrastructure projects. However, under current law, municipal bonds that are guaranteed by FHLBanks cannot qualify for tax-exempt status and, therefore, carry higher interest costs.

S. 1963, introduced in the Senate by Senators Rockefeller, Crapo, Stabenow and Carper, would address this impediment. The bill would amend Section 149(b) of the Internal Revenue Code by adding FHLBanks to the list of government agencies and government-sponsored enterprises (GSEs) authorized to provide credit enhancement for tax-exempt municipal bonds. Fannie Mae, Freddie Mac, Ginnie Mae, the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) have been permitted since 1984 to provide such credit support. A similar provision was included in the Housing Assistance Tax Act of 2008 (H.R. 5720) that was recently approved by the House Ways and Means Committee. Enactment of this measure would help to significantly lower financing costs on public infrastructure and other projects that are the foundation for meeting community housing and economic development needs.

Home Buyer Tax Credit

Two causal factors in the current housing downturn and the related credit crunch are declining house prices and excess inventory. These elements are equally central to the outlook for the broader economy and the financial markets. Policies that stimulate home purchases in the immediate future can pay huge dividends. The biggest bang for the buck most likely would be provided by a temporary homebuyer tax credit, such as the credits approved recently by the Senate in the *Foreclosure Prevention Act of 2008* and by the House Ways and Means Committee in the *Housing Assistance Tax Act of 2008*. Indeed, the recent revival of interest among prospective buyers suggests that temporary credits could stimulate a wave of home buying that could quickly reduce excess supply in housing markets and halt the dangerous erosion of house prices and mortgage credit quality. NAHB applauds the Congress for its efforts to create a homebuyer tax credit, and stand ready to work with Congress in crafting the most effective credit to help solve the current economic crisis.

Tax credits for the purchase of a home would be very effective economic stimulus tool. They are a means of eliminating excess inventory, relieving some of the pressure on falling housing prices, and ending the waiting-on-the-sideline strategy some potential buyers have adopted in response to overly negative media stories concerning the future of the housing market. As Alan Greenspan noted in November of 2007, reducing inventory is critical for the health of the economy, and a tax credit would be the easiest and most cost effective way to achieve this goal.

What is common amongst all of the various models of a tax credit for the purchase of a home is that they represent policies that increase housing demand, thereby enabling home purchases for families and fight falling housing prices, which threatens the economy as a whole. We recommend a targeted homebuyer tax incentive in order to maximize induced purchases. An effective temporary home buyer tax credit would restore confidence in the housing market for homeowners, homebuyers, builders and financial institutions, thereby reducing some of the factors responsible for the current credit crunch.

Expand the Net Operating Loss Deduction Carryback

Home builders, like many businesses, are now reporting financial losses when a few years ago they were generating jobs, providing local development and paying taxes. For home builders large and small the importance of the ability to claim and carry back net operating losses (NOL) deductions to years when significant taxes were paid cannot be overstated. The inability to do so will result in the need to either increase high-cost borrowing or further liquidate land and homes, which will only compound the existing inventory problem. The additional supply of homes and land on market for sale, of course, will put even more downward pressure on prices and further add to the housing crisis. Ultimately, the result of this will be more layoffs of workers and reduced development of communities.

Current law allows for a two-year carryback of NOLs, however, home builder losses began in 2006. Expanding the carryback of NOLs beyond two to years when significant taxes were paid provides financial resources to the home building sector as well as all businesses to weather the economic downturn. Further, this will help all businesses, including financial institutions and manufacturers, facing difficult economic decisions concerning employment. Finally, an expansion of the NOL carryback simply allows businesses to accelerate their claim of NOL deductions that under present law would be claimed in the future. The need for these deductions today is critical. NAHB thanks the Senate for approving a temporary expansion of the NOL carryback period to four years for tax years 2008 and 2009 as part of the *Foreclosure Prevention Act of 2008*. NAHB applauds Senators Snowe, Kerry, Coleman and Landrieu (R-ME) for their work on S. 2552, the *Small Business Stimulus Act of 2008*, which includes an expanded NOL carryback provision. These provisions will help all businesses with losses weather the economic downturn and emerge from this recession in a position to grow.

Expand the Mortgage Revenue Bond Program

The existing Mortgage Revenue Bond (MRB) program also offers a method of increasing housing demand. A special allocation of bonds to be used for either purchase or refinancing would be beneficial for housing. The MRB program allows state and local governments to issue tax-exempt debt that may be used to finance mortgages at below-market interest rates. Certain technical restrictions concerning the MRB program could also be made more flexible to enhance its use as an economic stimulus tool. These include the house price limits and the first-time home buyer requirement. Expanding the reach of the MRB program would allow it to have the largest effect, particularly for communities experiencing the possibility of a wave of foreclosures or an extreme excess of inventory. Such positive results will help reduce pressure on housing prices, thereby restoring financial institutions' confidence in the housing market and reducing the effects of the current credit crunch. NAHB thanks the Senate and the House Ways and Means Committee in approving a temporary $10 billion expansion of the MRB program. The industry looks forward to seeing it enacted into law in the near future.

Expand Small Business Expensing

Section 179 of the tax code allows small business to expense the cost of investment for business property. The Economic Stimulus Act of 2008 temporarily expanded the rules so that small businesses may expense up to $250,000 of qualified investment for tax year 2008 ($128,000 would have otherwise applied in 2008, with that amount indexed for inflation through 2011). The expensing benefit is phased-out for business incurring more than $800,000 in qualified investments in 2008 ($510,000 would have otherwise applied in 2008, with that amount indexed for inflation through 2011).

Home builders in general appreciate the opportunity that Section 179 expensing offers small businesses from both the tax policy perspective, as well as the administrative burden reduction that such rules offer. However, it is useful to remember that many builders currently have no taxable income to offset, so such investment incentives offer no effective relief. These incentives will be more important when the housing market rebounds in the future.

Conclusion

NAHB appreciates the opportunity to testify on behalf of our 235,000 members on critical issues related to small businesses impacted by the credit crunch and economic downturn. We look forward to working with the Committee, the Senate and the Congress to develop effective responses to these issues and policies to help ensure the continued viability of our nation's small businesses.

Chairman KERRY. We are delighted. Thank you very much.
Ms. Landis.

STATEMENT OF MARILYN D. LANDIS, PRESIDENT, BASIC BUSINESS CONCEPTS, INC., PITTSBURGH, PENNSYLVANIA

Ms. LANDIS. Chairman Kerry, Ranking Member Snowe, thank you for inviting me here today to discuss the impact of the credit crunch on America's small businesses. My name is Marilyn Landis and I am the Chair of the National Small Business Association. I also am the owner of Basic Business Concepts, a consulting and financial management company that provides temporary chief financial officer, CFO, assistance to other businesses, primarily in Pennsylvania and Ohio.

Even in the best of times, access to capital is one of the largest impediments facing America's small businesses, hindering both aspiring and thriving entrepreneurs. This perennial problem is exacerbated during troubled economic periods. According to a national survey of small and mid-sized business owners recently commissioned by the NSBA and unveiled today, and I would ask that it be read into the record, please, 55 percent of small and mid-sized small business owners have had difficulty securing credit in the last six months, and this finding is consistent across firm size and firm revenue size.

One of the biggest barriers to small business financing is requiring debt be secured by equity and fixed assets. Many small businesses lack the kind of equity necessary for traditional bank loans. This gap in debt-equity financing especially hinders growing businesses, as these entrepreneurs typically do not have the assets necessary to acquire sizeable loans.

Aggravating this state of affairs is the recent tightening of lending standards by banks. Even for those small business owners fortunate enough to qualify under the tightened standards, there is bad news, as banks are raising the cost of their credit lines and the premiums they charge for higher-risk loans. In addition to tightening their lending standards, more and more banks simply are dropping out of the lending programs offered by the SBA.

While insufficient access to capital has long been a lament in the small business community, the current capital vacuum has created a new predicament for small business owners, the use of credit cards. According to the NSBA survey, credit cards are a primary source of financing for America's small businesses. In fact, 44 percent of small business owners identified credit cards as a source of financing that their company has used in the previous 12 months, more than any other source of financing, including business earnings.

Banks require business borrowers to have either equity in hard assets or historic cash flow to support their loan requests. Rapidly growing service or technology companies that are not traditional brick and mortar, like mine, have neither. We are forced to use bank credit lines, which if not secured with equity in a home, are increasingly credit card accounts. I can personally attest to this phenomena. Two banks recently offered me a credit line and sent me a credit card.

Unfortunately, the credit card industry's underwriting practices——

Chairman KERRY. Zero APR, no doubt.

[Laughter.]

Ms. LANDIS. Wait, I will go on. Unfortunately, the credit card industry's underwriting practices and their reliance on risk analysis are an imperfect answer for small business access to capital needs.

For example, I have an American Express—I have been an American Express customer since 1989. In January of 2007, American Express increased my credit line based on my responsible credit history. They increased it to $7,000. Later that year, they increased it to $11,400. This increase was helpful, as I spent most of 2007 trying to expand my business. I hired two more people and opened two more offices. I also began expanding the zone of my business into New England and began traveling regularly—and exhaustively—to the region. As a result of my increased traveling, I began to run much higher monthly balances on my Bank of America credit card that I was using for business. I still paid on time, mind you, I just gradually was increasing the monthly balance, paying it off, but increasing it each month.

Despite being told by American Express that my credit line was valid as long as my credit was in good standing, I received a letter earlier this year informing me that as a result of the review of my account, my American Express line of credit had gone from $11,400 to $4,200. I was informed that this action was taken for the following consumer agency reporting reasons: Too many accounts with balances, too many inquiries the last 12 months, too many accounts recently opened, and the proportion of balances to the credit limit. There was no mention, as there is no history, of slow or non-pay.

Further, in December of 2007, I received a similar letter from another unrelated credit card informing me that effective January of 2008, my annual interest rate had skyrocketed from the promotional 3.99 percent to 27.99. This increase was attributed to information obtained from a major credit reporting agency. Again, keep in mind, I had no record of slow pay or non-pay. I am being penalized for growing.

America's small business owners think there are a number of steps that Congress could take to help to help alleviate the effects of this credit crunch. One is strengthen the SBA's lending programs and other federally backed loan programs for entrepreneurs. The fee the SBA charges both lenders and borrowers must be reduced and the lending process must be streamlined.

Second, reform the practices of the credit card industry. In order to address the practices that are making a small business increasingly difficult and hindering the economic development of the nation's small businesses, NSBA supports the credit card reform initiatives going forward. NSBA also urges Congress to remain vigilant of any unintended consequences arising from the enactment of credit card reform. There is a provision in a recent bill before Congress that would make it detrimental for small businesses to use credit cards in an attempt to protect the consumer. While the provision may make sense when applied to seniors or other consumers, it would wreak havoc on the 44 percent of entrepreneurs in this country that rely on credit cards to finance their business.

NSBA appreciates the recent efforts to boost the nation's sagging economy. America's small business owners are convinced, however, that the effort to ward off financial ruin on Wall Street should be equal to the effort to stave off the economic disaster on Main Street.

We thank you for your time to address that and we welcome your questions.

[The prepared statement of Ms. Landis follows:]

NSBA
National Small Business Association®

TESTIMONY OF MARILYN LANDIS

OWNER,
BASIC BUSINESS CONCEPTS, INC.

CHAIR,
NATIONAL SMALL BUSINESS ASSOCIATION

"The Impact of the Credit Crunch on Small Business"

Before the U.S. Senate Committee on Small Business and Entrepreneurship

April 16, 2008

Good morning, Chairman Kerry and Ranking Member Snowe; thank you for inviting me here today to discuss the impact of the credit crunch on America's small businesses. My name is Marilyn Landis and I am chair of the National Small Business Association (NSBA), America's oldest small-business advocacy organization. I also am the owner of Basic Business Concepts, a consulting and financial management company that provides temporary chief financial officer (CFO) assistance to other small businesses, primarily in Pennsylvania and Ohio—but I am expanding, or at least trying to expand.

Prior to starting Basic Business Concepts, I spent 30 years working for and with commercial lenders, banks and small businesses throughout western Pennsylvania. I worked for three of the largest U.S. Small Business Administration (SBA) lenders in the country and have continued working with my clients on securing SBA loans and myriad other sources of capital. After 37 years of working with small businesses, the one thing I can tell you without hesitation is that it is not easy to start or develop a business. Entrepreneurs must overcome a host of obstacles to create and expand their businesses.

The credit crunch currently is among the most daunting of these obstacles.

SMALL-BUSINESS CHALLENGES IN FINANCING

Even in the best of times, access to capital is one of the largest impediments facing America's small businesses, hindering both aspiring and thriving entrepreneurs. In fact, the small-business members of NSBA consistently identify access to capital as one of the top-10 issues impacting their firms.

This perennial problem is exacerbated during troubled economic periods, such as those we are experiencing now. According to a nationwide survey of small- and mid- sized small business owners, recently commissioned by the NSBA and unveiled today (henceforth: NSBA Survey), 55 percent of small- and mid- sized small business owners have had difficulty securing credit in the last six months—and this finding is consistent across firm size and revenue.

One of the biggest barriers to small-business financing is requiring debt be secured by equity in fixed assets. Many small and startup businesses lack the kind of equity necessary for traditional bank loans. This gap in debt-equity financing especially hinders startup and growing businesses, as these entrepreneurs typically do not have the assets necessary to acquire sizeable loans.

It is important to note that home ownership rarely meets the equity requirements necessary to acquire a larger commercial loan. Only ten percent of small-business owners leveraged their business loans through a second mortgage, according to the NSBA Survey—yet this represents the third most popular avenue of business financing after credit cards and business earnings. Of course, many of the small-business owners who were lucky enough to leverage their business financing with their home equity are regretting it now. With home prices plummeting, many are discovering that they owe more than their homes are worth.

Another barrier to capital for small businesses is that banks too often shy away from the small-business community. Smaller loans generally are less-profitable for banks and typically have higher default rates. Additionally, the proper valuation and credit worthiness of small businesses are notoriously difficult to determine. Ongoing bank consolidation has lead to fewer community banks and fewer character-based loans as well.

Aggravating this state of affairs is the recent tightening of lending standards by banks. According to the Federal Reserve Board's January Senior Loan Officer Opinion Survey, one-third of domestic banks have tightened their standards on commercial loans over the last three months. Even for those small-business owners fortunate enough to qualify under the tightened standards there is bad news, as banks are raising the costs of their credit lines and the premiums they charge for higher-risk loans.

In addition to tightening their lending standards, more and more banks simply are dropping out of the lending programs offered by the U.S. Small Business Administration (SBA). In fact, 368 banks have quit the programs in the last two years, and there has been a 47-percent decrease since 2001 in the number of banks making at least one 7(a) loan. Much of this withdrawal is due to the SBA's increased fees, which are at their statutory limit for the 7(a) program. Furthermore, although the SBA likes to tout that the number of 7(a) loans is rising, the dollar volume of those loans is shrinking, decreasing by 14 percent compared to last year. Government guaranteed loans overall have shriveled by as much as 23 percent compared to last year.

SMALL BUSINESSES' RELIANCE ON CREDIT-CARD FINANCING

While insufficient access to capital has long been a lament in the small-business community, the current capital vacuum has created a new predicament for small-business owners: Use credit cards or bust. According to the NSBA Survey, credit cards are a primary source of financing for America's small businesses. In fact, 44 percent of small-business owners identified credit cards as a source of financing that their company had used in the previous 12 months—more than any other source of financing, including business earnings. In 1993, only 16 percent of small businesses owners identified credit cards as a source of funding they had used in the preceding 12 months.

It is important to note that this dramatic increase does not represent only emergency or short-term usage. Of the small-business owners who use credit cards as a source of funding, 71 percent report carrying a balance month-to-month. This is up from 64 percent in 2000. Twelve percent of small-business owners are carrying a balance of more than $25,000, and 33 percent are carrying a balance of more than $10,000. This suggests that credit cards have replaced term loans to fund expansion needs. This hardly is surprising when one considers that the "credit card industry is typically the most profitable in the banking sector, earning a return on assets since 1995 that is more than three times greater than that for commercial banks overall," according to Travis Plunkett, legislative director at the Consumer Federation of America.

Many small-business owners first turned to credit cards as their primary source of working capital in the early years of this decade—when a multitude of banks last tightened their lending standards. Bank regulators require business borrowers to have either equity in hard assets or historic cash flow to support their loan requests. Rapidly-growing service or technology companies that are not traditional brick and mortar, like mine, have neither. We are forced to use bank credit lines which, if not secured with equity in a home, are increasingly credit-card accounts. I can personally attest to this phenomenon, as not long ago I applied for a "line of credit" with Wells Fargo and instead received a new credit card. The same was true more recently when National City Bank offered a credit line and sent a credit card.

THE TROUBLE WITH SMALL-BUSINESSES' RELIANCE ON CREDIT-CARD FINANCING

Under current law, credit cards are permitted to have significantly higher and more volatile rates and payment structures than traditional bank loans. According to Professor David Walker, of the McDonough School of Business at Georgetown University, "Small firms that rely on debt secured by credit cards usually pay more than twice the interest rate that large firms pay when borrowing at the prime rate."

This fact is not lost on most small-business owners. Although increasingly reliant on credit cards for financing, most small-business owners do not think they are getting a good deal. In fact, among those using credit cards for financing, 57 percent think that the terms of their cards have worsened over the last five years. This perception only appears to be growing. Two-thirds of the respondents to a very recent NSBA quick poll reported noticing an increase in the fees associated with their credit cards in the last three months. The same quick poll revealed that 56 percent of respondents had experienced an increase in their credit card interest rates in the last three months or had received notice that their issuer planned to increase them in the near future.

I, personally, can speak to another problem: The credit-card industry's underwriting practices and their reliance on "risk analysis" are an imperfect answer for small businesses' access to capital needs; and I would like to illustrate this point with an example from my own experience. I have been an American Express customer since 1989. In January 2007, American Express increased my credit limit, based on my "responsible credit history." The letter I received announcing this increase stated, "Effective immediately, your new credit line is $7,000.00 and it will appear on your next statement. This new line will be valid on your account as long as your credit is in good standing." Later in the year, this line of credit was further increased—to $11,400.00.

This increase was helpful, as I spent most of 2007 trying to expand my business. I hired 2 more people and opened 2 more offices. I also began expanding the zone of business into New England. Having primarily focused on Pennsylvania and Ohio in the past, I began traveling regularly (I would say, exhaustively) to the northeast region. As a result of my increased traveling and efforts to expand my business, I began to run much higher monthly balances on the Bank of America credit card I use for business. I still paid on time, mind you; I just gradually acquired more debt.

Despite being told that this line would "be valid … as long as your credit is in good standing," I received a letter early this year—dated January 2, 2008—informing me that as a result of a review of my account, American Express was changing my Line of Credit. My $11,400.00 line of credit was reduced back to $4,200.00. I was informed that this action was being taken for the following reasons:

- "Information received from a consumer reporting agency."
- "Our analysis of the credit risk associated with customers who have residential loans from the creditor(s) indicated in your credit report."

The letter elaborated that the consumer reporting agency factors that affected their decision were:

- "Too many accounts with balances."
- "Too many inquires last 12 months."
- "Too many accounts recently opened."
- "Proportion of balances to credit limits on bank/national or other revolving accounts is too high."

There was no mention—as there was no history—of slow or non-payment.

In December 2007, I received a similar letter from Bank of America for an unrelated card, informing me that effective January 2008, my annual interest rate was skyrocketing from a "promotional rate" of 3.99 percent to 27.99 percent. Thankfully, this interest hike only applied to future charges and was not retroactively applied to my outstanding balance. This increase was attributed to "information we [Bank of America] obtained from your account, as well as from information reported by a major credit reporting agency." Keep in mind, I had no record of slow or non-payment.

In other words, as a small-business owner trying to expand a service company that lacks sufficient equity to secure a traditional bank loan, I am forced to use credit cards to finance my firm's growth. If I actually use the credit cards that I am forced to turn to, however, the issuers are liable to ratchet back the credit previously promised to me. If I seek out additional capital from a different credit card, the result is likely the same.

Let me detail another personal incident that demonstrates the inconsistent and unpredictable nature of current credit card practices. I have an Advanta credit card for which I carried an average daily balance of $5,506.22, at 2.99 percent. In November 2006, I received a cash advance—for which I paid a $50 fee, interest on the fee, and 11.49 percent interest on the advance—from the card in the amount of $14,317.77, at 11.49 percent. There was no other activity and when my $455 bill arrived, I paid it on time. Therefore, I was surprised to see my cash advance interest rate swell from 11.49 percent to 20.01 percent in my December bill. Equally surprising was that my average daily balance, for which I was paying 2.99 percent, had dropped to $1,779.86, while the rest of my outstanding balance, for which I was paying 19.99 percent, jumped up to $17,333.50 with no explanation. One can imagine how difficult it is to adhere to a business plan with this sort of unpredictability lurking in every expenditure.

This unpredictability does not end with unexpected interest-rate hikes. Let me share with you another story—this one dealing with a Bank of America credit card I opened in November 2006. For this card, Bank of America promised a zero-percent interest rate until September 2007. Unfortunately, it did not quite make it. I received my December bill on Jan. 3, 2007. It was dated Dec. 26, 2006—the day after Christmas—and due on Jan. 20, 2007, which was only 17 days away. I mailed my payment on Jan. 5. Bank of America said they received my payment on Jan. 22 so I was charged a $49 late fee. Oh, and my zero-interest rate credit card suddenly sported a new and improved 22.24 percent interest rate. Thankfully, I am only being charged $1 a month on my existing balance for this card, but any new expenditure is being charged at the new interest rate and any remaining balance would be charged at that rate come September. In the meantime, I am stuck with a card that I cannot and will not use, while the mere existence of the card hinders my ability to garner additional capital.

There is one predictable aspect of my Bank of America card: the monthly payment due dates are never the same, fluctuating by several days in the last seven months, from 12/19/06 to 1/20/07 to 2/20/07 to 3/23/07 to 4/20/07 to 5/21/07 to 6/19/07. The statement cut-off has remained the same during this time. The same can be said of my MBNA card, since it was sold to Bank of America. Previously, the due date was the 27th of the month. Between December 2006 and April 2007, the due dates for this card fluctuated greatly, from 12/28/06 to 1/27/07 to 2/24/07 to 3/22/07 to 4/22/07. Again, the statement cut-off has remained the same during this time.

This inconsistency makes running a business more challenging and perilous. I practice and I instruct my clients to use debt wisely, plan carefully for that repayment, and stick faithfully to that plan. Without a consistent, predictable debt instrument small businesses like mine without home equity based loans are often caught in financial turmoil. Now, with the recent mortgage crisis, even the previously fortunate entrepreneurs who had home equity based loans are facing turbulence.

RECOMMENDATIONS

America's small-business owners recognize that the current credit crunch cannot be legislated away—as much as we, and the Congress, might wish the opposite. There are, however, a number of steps that we think Congress can take to help alleviate its effects.

Strengthen the SBA's lending programs and other federally-backed loan programs for entrepreneurs. The fees the SBA charges both lenders and borrowers must be reduced; and the Microloan program must be funded. *S. 2612, the Small Business Lending Stimulus Act of 2008*, recently introduced by Sen. Kerry, is a good starting point. The lending process itself must be streamlined as well. While securing a new credit card no doubt will remain regrettably easier than securing a 7(a) loan, the disparity can be reduced.

Reform the practices of the credit-card industry. The billions of dollars generated from outlandish retroactive interest rates hikes, the escalating imposition of undisclosed fees, and unilateral and unforeseen interest-rate increases is money diverted from economic development. For small businesses, it means less money to advertise or invest in new equipment or hire new employees. Almost a third of small- and mid-sized businesses say that they would hire additional employees if more capital were available to them. More capital might be available if so much of it was not being siphoned off by the unacceptable business practices of the credit-card industry. In order to address the practices that are making running a small business increasingly difficult and hindering the economic development of the nation's small businesses, NSBA supports the following credit-card reforms:

- Prohibit the practice of universal default,
- Prohibit the practice of double-cycle billing,
- Prohibit the retroactive application of interest rate hikes—interest rate increases only should be applied to future card usage,
- Limit the interest rate percentage increases that card issuers can impose on holders,
- Require card issuers to apply a customer's payments to the card balance with the highest interest rate first,
- Prohibit extra interest charges on card debt that the cardholder already paid in full,

- Prohibit interest charges on transaction fees,
- Prohibit late fees if an issuer's action caused a delay in crediting a payment, and
- Establish an industry-wide practice regarding the time on which a payment must be received or sent to be considered on time.

NSBA also urges Congress to remain vigilant of any unintended consequences arising from the enactment of credit-card reform legislation. Provisions such as those in section 6 of the recently introduced *S. 2753, the Credit Card Reform Act of 2008*, would be highly detrimental to America's small businesses and economy. This highly problematic section requires credit-card companies, before issuing a credit card, to verify an applicant's ability to pay. The ability to pay would be based on an applicant's current and expected income, current obligations, and employment status, using a formula provided by the Federal Reserve Board.

While such a provision may make sense when applied to a student or senior, it would wreak havoc on 44 percent of entrepreneurs in this country that rely on credit cards to finance their businesses. How can a small business owner verify her employment status? How will the Fed's formula project a fledgling business's "expected income?" How will an entrepreneur's potential lack of income affect her ability to finance her business? Such questions are too important to remain unanswered.

CONCLUSION

NSBA appreciates the Federal Reserve Board's recent efforts to boost the nation's sagging economy. America's small-business owners are convinced, however, that the effort to ward off financial ruin on Wall Street should be equaled by the effort to stave off economic disaster on Main Street. Slowing or reversing the impact of the credit crunch on America's small businesses will stimulate job creation and fuel the nation's sputtering economy. As this Committee well knows, small businesses are the engine of the U.S. economy. They comprise 99.7 percent of all U.S. employer firms and more than half of all private-sector employees. Perhaps most importantly, they have created 93.5 percent of all net new jobs since 1989. Spit-polishing the chrome of America's economy, while ignoring its engine, isn't going to win us any races.

I thank you for your time and welcome any questions.

Chairman KERRY. Well, thank you all very, very much. It is a pretty stark picture you all draw in the conglomerate. It is very important testimony and very helpful testimony.

Can I just ask you a question. I mean, you are a business president and owner. Did you know that that rate could go up to 27 percent?

Ms. LANDIS. No. One of the most difficult parts—obviously, working as a CFO, I counsel my clients on the wise use of credit or no credit at all is better. You don't want to be over-leveraged with your business. I spent 30 years as a banker. I understand the credit risks. One of the most difficult parts about credit card debt is that you are subject to the volatility of the terms and conditions of payment and interest rate change.

Chairman KERRY. But they reserve the right to essentially raise it whenever they want.

Ms. LANDIS. Correct.

Chairman KERRY. Without an understanding of what that might be or terms, correct?

Ms. LANDIS. Correct, and what was significant, particularly with the credit line decrease, I got the letter announcing an increase to $11,400 on the seventh of January and the decrease on the eighth of January.

Chairman KERRY. Mr. Mitchell, what do you do in this situation? You are sort of the prisoner, in a sense, of forces over which you don't have control that we were talking about earlier with the Governor of the Fed. Do your lenders sit with you and kind of give you a sense that they are willing to hang in there with you or are they putting pressure on you in this circumstance?

Mr. MITCHELL. Senator, I have been through four of these downturns and I learned a long time ago in making my way through them that you go to your lender as soon as you realize that conditions are such that they could worsen or you could be in trouble. And so that has been going on for a number of months. And I will tell you that I think the lenders with whom we are dealing today have been really as cooperative as they could and they are trying to work with us.

However, as I pointed out, this downturn has been going on for such a lengthy period—we are over 30 months in the downturn that started in 2005—that interest reserves are running out and the term of the loans are running out, and if they go back to renew their loan then the appraisers are saying, well, the property values are going down and they are asking for equity to meet the regulator's standard.

So it is a difficult situation and you only have but so much capital and my objective is to pay them all in time, which is the solution, but also to keep my business, which as I said has been going on for 33 years.

Chairman KERRY. It has been going on for 33, but it sounds like if you are laying off 40 percent of your employees, and what was the other figure? Forty percent of your employees and——

Mr. MITCHELL. I am not sure there was another. Well, I said I have tapped my personal resources. I am putting capital back in the company.

Chairman KERRY. How long can you do that?

Mr. MITCHELL. It is questionable, but my suggestion is that we have probably got anywhere from six to nine months before we would be in dire straits.

Chairman KERRY. Secretary O'Connell, you said in your testimony the community banks are suffering a crisis of confidence and they are afraid to make a long-term loan. You have been through this a lot under various incarnations, but how do you break that at this point? Can public policy—is there something that we can do that kind of gives them, okay, it is okay to go out and do this now, or is it going to have to happen because the market has kind of bottomed out, people know it, and they suddenly see the demand for housing growing so fast because there is a lot on the market and it is cheap and all of a sudden the psychology turns? Which is which? Is there a chicken and egg situation?

Mr. O'CONNELL. I think the actions you have taken, Senator, on the foreclosure issue are a step forward in easing that crisis. We need to see what happens in the House now and how the eventual——

Chairman KERRY. You are talking about the mortgage revenue bonds and put cash out there so people can actually make the loans and so forth.

Mr. O'CONNELL. Yes, sir. I think the feeling is that that will help to find the real pricing, which is what needs to happen for that confidence to be restored, and I think these smaller and community banks, fairly small staffs. I was talking to one. Five members of the total banking staff, two of whom do nothing but Federal and State paperwork. It is a tough time and they are worried about increased regulatory oversight and making mistakes that would cause them to endanger their institutions.

So bringing back a level of support, signs like the legislation you have proposed involving simplifying some of that paperwork, dealing with some of the fee issues, providing more capital to back up their efforts, all of that will help to ease the crisis, I believe.

Chairman KERRY. At the State level, have you convened groups of or all of these lenders at some point in time and kind of had a discussion with them where you try to do some of this and restore that?

Mr. O'CONNELL. One of the things I have found, and I am sure you do it already, Senator, is that Massachusetts is not one economy, it is a series of regional economies—the South Coast, the Western part of the State, the older mill cities. And the solutions—one size does not fit all in our State. So what we have tried to do, the Governor and I both, is reach out and meet with roundtables and banking and business groups in the various regions. It is something you have done in the past that you have suggested in the foreclosure are. And we are finding that that is the most effective way to deal with really our local concerns and issues, which vary around the State.

Chairman KERRY. I know you also mentioned in your testimony the tightening that you have perceived with respect to student loans among these. Since we have about 140 colleges and universities, that is a big base for us. To what degree is that really being experienced or felt out there?

Mr. O'CONNELL. We are deeply concerned. It is our second-biggest industry in Massachusetts after health care, education. It is a key to the economy. It is one industry where we have been growing jobs over the last year, last 15 months. And if student loan availability tightens as we think it will—it is just beginning to happen—MEFA, Massachusetts Education Finance Authority, announced yesterday that they will no longer be doing federally-guaranteed loan activity because the secondary market for those loans has dried up—it could be a crisis in one of our key industries if drop-off of five percent of the students who thought they would be there in the fall but can't put the loan package together to meet the needs.

Chairman KERRY. You also mentioned the CAP program, the Massachusetts Small Business Capital Access Program. Would you liken that to the SBA's 7(a) or do you draw distinctions?

Mr. O'CONNELL. No, I think it is quite similar. It has been a great leveraging opportunity. We have seen——

Chairman KERRY. And what kind of fees do you charge in comparison with what the SBA does?

Mr. O'CONNELL. I think the fees average about a third of what the SBA does. CAP's fees to the borrower average approximately 3 percent of the loan amount, which is slightly less than the SBA's for loans in the $150,000 to $700,000 range. However, CAP's fee is one time and paid at the loan closing. For loans that exceed $700,000, the SBA's fees increase; they also charge a servicing fee for each year the loan is open, so over the life of the loan, their cumulative fees to the borrower can be significantly higher than those of CAP.

Chairman KERRY. A third of the SBA.

Mr. O'CONNELL. Of course, we have had to recapitalize that program and both the legislative houses in Massachusetts have approved a $5 million recapitalization of the program.

The Capital Access Program is designed to help small businesses with less than $5 million in revenues throughout Massachusetts obtain loans from participating banks. Using cash collateral guarantees from a loan loss reserve fund, this program enables banks to make loans they might otherwise be unable to grant. The Business Development Company administers the CAP program on behalf of the Commonwealth of Massachusetts.

Accessing the CAP program is very simple and requires no extra work on the part of the borrower; there is no application form to fill out. When a business applies to a participating bank for a commercial loan, the bank will determine whether the loan requires credit enhancement and then it is the bank which submits an enrollment form to CAP. The enrollment form is less than a page in length and the bank negotiates all loan terms with the borrower directly, including pricing and the level of guaranty premiums required. It is also the bank that commits and funds the loan, following its own procedures within its timeframe. The borrower only has to deal with his/her bank, thus making the process very simple and easy.

Chairman KERRY. Ms. Landis, I meant to ask you, in terms of the tightening of the credit impacting your business, what have you not been able to do as a consequence of that?

Ms. LANDIS. I haven't been able to expand. I have——

Chairman KERRY. You were planning to? You were about to?

Ms. LANDIS. I was planning to expand into Michigan. I am actively expanding into New England. I have had inquiries for my business here in the D.C. area and up in Michigan. I am just unable to invest in the additional people, computers, and travel to do that.

Chairman KERRY. And why will an SBA loan not fill that gap? If you are able to do that, why won't that work?

Ms. LANDIS. An SBA loan would perhaps fill that gap if I felt I had a confident way to repay that and I planned it carefully. However, I don't have any equity in my home. I had a fire and I used the equity in my home to rebuild my home, so I have no equity to use to borrow against, so that option is not out there for me.

Chairman KERRY. I see. I see. So you have got to get the capital just through your revenue stream and go report back in, or find some kind of investment——

Ms. LANDIS. Well, the other thing that has hurt me, as I mentioned with the credit card increase, when I am increasing travel to New England, the client pays for my travel. So that is not necessarily an expense of my business. Those credit card balances that have been growing are repaid monthly as my client pays me for my invoices. So it is simply the growth of my business and the cash flow of that business that has caused me to be impacted with my one credit card being cut and the other one the rate being increased. The economic model that is out there was looking at a credit score based on use, not the underlying business principle that was causing my business to have more revenue, more profit, and more opportunity.

Chairman KERRY. What would make the greatest difference to you now? What would change this playing field as you are currently on it?

Ms. LANDIS. An opportunity to have the community bankers and other bankers have access to the business plan that I have, the cash flow that I have, the underwriting that I have, instead of relying on a credit score model that offered me an unsecured loan only based on credit scoring.

Chairman KERRY. So if you had a different way of judging your creditworthiness, you believe you could meet a viable standard by which they would be repaid and they could make a loan?

Ms. LANDIS. Thirty years ago, I was with a commercial lender for 30 years, and I know there are also a lot of loans that should not have been made because the credit scores look good and the underlying business plan and the opportunity to repay that with cash flow from the business wasn't there.

Chairman KERRY. Now, Ms. Blankenship, sort of picking up on that, in your testimony, you say that lenders, community lenders are ready to lend, but you say the bank regulators are going to insist on a tightening of that standard, not looking perhaps to a different standard like Ms. Landis is talking about, right in the middle of the economic slowdown. Are you seeing that tightening?

Ms. BLANKENSHIP. I believe that our community banks are seeing that tightening.

Chairman KERRY. The regulatory tightening?

Ms. BLANKENSHIP. The regulatory tightening——

Chairman KERRY. Is that not wise for them? I mean, don't they have a responsibility to take a look and say, whoa, we may not get repaid here. We can't have another S&L crisis.

Ms. BLANKENSHIP. I think that it is a reaction from the subprime, basically the subprime meltdown.

Chairman KERRY. Does it, in your judgment, have a relationship, a nexus to the realities of the economy and the creditworthiness?

Ms. BLANKENSHIP. Yes, I believe it does, and that is why I think it is so important for the SBA program to be more friendly for the community banks to use, because right now in this downturn of economic time, we live by our small business customers. Community banks survive by small business. They are partners in the community and we have to have the tools to be able to provide more capital. And the fact is that we can't make the terms on some of the loans that we could under the SBA guidelines, the extended terms, and that is when the small businesses need those terms are in times of economic downturn. And it also provides us, by using SBA, the ability if we desire to sell the guaranteed portion, obtain more liquidity, therefore we have more funds to turn around and loan back to other small businesses.

Chairman KERRY. If the fees were reduced, say by half, or you put a moratorium on the fees for six months or so, would that be an incentive, in your opinion?

Ms. BLANKENSHIP. I believe it would be a huge incentive for both the banks and the——

Chairman KERRY. Is SBA here?

Ms. KIRK [continuing]. Small business.

Chairman KERRY. You believe it would be?

Ms. BLANKENSHIP. I believe it would certainly.

Chairman KERRY. Do you believe this discussion we had with the Administrator is legitimate with respect to fee impact?

Ms. BLANKENSHIP. I certainly do. I had a similar conversation with him before the hearing began, because we have been an SBA preferred lender since the late 1980s, but we have seen a decrease in our program just because of the fees and the paperwork. We are a small community bank. We are committed to the program. But if we can't make it work, other community banks can't make it work.

Chairman KERRY. Secretary O'Connell, do you agree with that?

Mr. O'CONNELL. I fully agree. The evidence I have heard as I have traveled round the State suggests that the fee impact is significant and the paperwork impact, as well. The Low-Doc program that was talked about, a return to that kind of program, I think, would have an immediate upturn——

Chairman KERRY. I helped start that program when I was on the Banking Committee. We started the Low-Doc program and I saw the impacts of that immediately. It was terrific, a simple way to get the credit to move.

Why is your bank still doing this, given that? I mean, we have had all these banks drop out. You haven't.

Ms. BLANKENSHIP. The reason that our bank still uses SBA is because it is a viable answer for small businesses and we have even——

Chairman KERRY. You believe in it?

Ms. BLANKENSHIP. I believe in it, and it affords us the ability and opportunity to provide capital that fits that small business—their model, their business model, when they need long-term financing for cash flow and inventory, which we couldn't necessarily do because under regulator guidelines, we would fall under certain criticism.

Chairman KERRY. Mayor Kirk, I know this is affecting property values, and therefore it affects your revenues, and therefore that can affect your choices with respect to school and infrastructure and police and fire. Those are your options. But my question to you is, in what ways is it affecting the city's cash flow itself, other than that? Is the credit crunch directly impacting your ability to do some of the things that you have laid out in your budget?

Ms. KIRK. The tax policy in Massachusetts, as you know, is a cap on property value, and the rest of the budget is driven through growth, housing and commercial development. So what we have in my city is a structural deficit where revenues are flat, or just increase on a very slow glide, and the expenses are far outpacing. So we are in this constant cycle of cutting budgets. We closed an elementary school last year. We have closed fire stations. We have—the skyrocketing water and sewer rates impact small business who have to pay that bill, as well.

So the credit crunch is prohibiting these small businesses from doing the improvements to their property or expanding their commercial base, if they are in that mode, which has a direct impact on the bottom line, because the balance of the revenues for the city is either off what we can capture in the property tax increase, which is only two-and-a-half percent under our tax policy, and all the rest is from new growth. So we have a very dismal economic picture in my city in Massachusetts.

Chairman KERRY. So leaving aside the direct Federal grants for water treatment and/or some of these specialized programs that we passed that you benefit from, i.e., some of the education money and some of the other areas, transportation and whatever it is—leaving those aside, what do you think at this point the Federal Government might do or could do that would have the most impact on your ability to maintain the quality of life and meet your responsibilities?

Ms. KIRK. I think the direct grant piece on the infrastructure is very, very important.

Chairman KERRY. I agree, but leaving that aside, is there something else you see? I mean, obviously, whatever earmark we could get within the appropriations process that is authorized and appropriate——

Ms. KIRK. Right. Well, I mean, this gets to be a very local scenario where we are a port city and we have a number of infrastructure assets and we have an open harbor and we have a lot of demands placed on us through Homeland Security and we are cast in a region that is suburban and we really should be considered as an urban port. And so we don't have the capacity to really take on the protection of the harbor and the assets that we have in our city as an urban center through proper staffing of public safety. I mean, we are really severely depleted in those areas. So——

Chairman KERRY. I just want you to know, I have sent a letter to the Secretary of Homeland Security, Secretary Chertoff, on that subject based on a conversation we had previously, so we are trying to see if there is some leeway there.

Ms. KIRK. Yes. So I am a big believer in earmarks, because that kind of an earmark would absolutely help Gloucester specifically.

The other things are just to look at the unfunded mandates, because again, when you talk about education, we divert funding away from things that enhance the quality and bring joy, basically, to education to the mandated programs and to keep those other programs in our schools, we turn to the community. We fundraise. We have auctions. And that is all small business. We have 800 small businesses in our Chamber of Commerce and they are bombarded with the public schools and different organizations who have their hand out. It is just not sustainable. We are trying to patch together some solutions.

So I think unfunded mandates have an impact on the overall picture, and that is why I say in my testimony to, when you look at the credit crunch, really evaluate all of the fiscal impacts, because any one of them, a resilient small business could overcome, but because they are stacking up, it leads to that sort of downward spiral.

Chairman KERRY. Well, thank you. That is helpful. I know it is a bleak picture. It is a tough picture, but it certainly underscores and helps to bring home here the interrelatedness of all of this.

We are going to have to wrap up in a couple of minutes because I have a meeting with Senator Levin and Senator Boxer, but let me just, Dr. Bornstein, come back to you for one second. Very interesting observations about valuation and the home equity piece, which I think is really important, and we have heard it hear from Ms. Landis and others. The New York Times had the very interesting article over the weekend about this issue of home valuation, et cetera, and we see a whole bunch of small businesses that are facing a shrinking of their credit line even where the value of the home has not declined, or even where the value of the homes around the home have gone up. What can we do about that? How do we—is there a solution that can help get these banks to not treat this thing in a broad-based swath?

Mr. BORNSTEIN. Actually, based on the six years of research that I have done, I have come to various conclusions, again, related to small business failure and related to personal financial literacy. There is a lack of confidence in the American consumer and the small business community because of the small business failure rates, which many people recognize and we see through the documentation. If we can somehow make a dent and indicate to the banking community and the small business community that we have an opportunity here to make you operate smarter, that will increase confidence. I have spoken to a subprime conference in September 2007 and I basically told them that in the securitization industry, risk has drawn the value of all the securities down.

If we can somehow show that small business and individuals can be made smarter through financial literacy education to avoid making the wrong moves and stay on the right track, that will generate a greater confidence, I think, in the small business person's ability to succeed, and the individual's ability to meet those payments and avoid foreclosure. Those resets are going to be on for the next two, two-and-a-half years. We still have a chance to help these small business owners and, by the way, they are also individuals, because we see them in bankruptcy, a lot of those supposedly personal bankruptcies were actually small business owners who were part of the bankruptcy problem.

So, what I am suggesting is that we have this opportunity to basically turn it all around, but the problem is, unfortunately, we have been giving financial literacy education which I view as almost like a vitamin supplement to a cancer patient. It has to be specific, effective financial literacy education. The research that I have done basically was three-fold. It was a discovery process. It was a discovery of content and also delivery. How can we deliver financial literacy education?

So in answer to the question, I think a gaining of confidence by the banking community and the individual and the small business community that they will be able to stay on track and be able to make those payments, that, I think, will go a long way. Again, it is all about confidence, isn't it?

Chairman KERRY. Well, it is, I think. A lot of it is confidence, anyway. Some of it is sort of the practical steps you can take to instill that confidence, but it is.

Do you survey your folks about the bankruptcies, Ms. Landis? Do you survey or not?

Ms. LANDIS. I don't know that we have done that recently within our survey. It was not in the results I looked at this morning. It is something we could look at, and if we have it, we will get it to you.

Chairman KERRY. Well, let me just say to all of you, boy, this is crunch time in every respect, and I am so concerned and disturbed to see a kind of double-talk going on. On the one hand, the White House and the administration and other people in public life bemoan the lack of confidence and the impact and sort of acknowledge there are effects here of psychology. On the other hand, they don't do anything to break the cycle or to adequately intervene.

I was not enormously enamored by the stimulus package that we passed here, which gave people sort of a quick hit cash inflow but did very little to create jobs, and I argued vehemently that anything we did then should have dealt with the housing crisis. We won that in the Finance Committee, got it onto the floor, and it was lost on the floor due to some of the partisanship that got wrapped up, and ideology, in the Social Security/LIHEAP and other things, and I understand some of the restraints people felt about the breadth. But the bottom line is, none of the underlying factors were really addressed and we are still struggling now.

We have got a housing bill that has passed here, the Foreclosure Act, as it is called. It has got too many goodies in it for some of the folks who created the problems and hopefully we can work that out. But this has got to get out to you. I mean, it has got to get out there fast and I don't sense that urgency somehow in the response.

I know it has got to be frustrating for you, particularly, Mr. Mitchell, somebody like you, or Ms. Landis, where you are sitting there and it is your hide and your bank account and your home and your family and your workers that are on the line in a very real way. So I am very sympathetic. Or, Mayor, your small businesses, the 800-plus that you are struggling with.

So we have got to somehow move this. I think your testimony here has been helpful. I know there are some folks from the SBA sitting here. I am confident—I hope they will report to the Administrator, and I look forward to following up with him personally on not just the legislation we have that Senator Snowe and I have talked about, but also on how we might sort of proactively try to address some of these things in a coordinated way. This shouldn't be partisan and it shouldn't be lost in any politics. So I hope we can do that.

So thank you for taking the time to be here. Thanks for caring. Thanks for fighting back. Hopefully, we can join you in that effort and get the job done. I appreciate it.

We stand adjourned.

[Whereupon, at 4:55 p.m., the committee was adjourned.]

APPENDIX MATERIAL SUBMITTED

Statement of Senator Carl Levin
Committee on Small Business and Entrepreneurship Hearing on
"The Impact of the Credit Crunch on Small Business"
April 16, 2008.

Mr. Chairman, small businesses need access to credit in order grow or sometime just to stay in business. When our economy is in or nearing recession, one of the first groups to be hurt is small business, in part because of reduced access to credit.

Small business owners know that Michigan citizens have been contending with lost jobs, mortgage foreclosures and tight budgets for too long. Michigan has the highest unemployment in the nation, more than one million people without adequate health care, and our state has lost over ¼ million manufacturing jobs since January 2001. Businesses and citizens alike deserve prioritized government efforts to help get our economy back on track that are responsive to the challenges they are facing day in and day out.

SBA's Office of Advocacy acknowledges that new business creation is key to increasing a state's employment. Since small businesses are a key contributor to job creation, assisting small businesses during an economic downturn is of critical importance.

This is where SBA's role is so important because SBA's programs are designed to help small businesses when the private sector may not be doing so. For instance, a recent Urban Institute Study commissioned by the SBA determined that SBA programs help small businesses by getting credit to small businesses that cannot obtain credit elsewhere. These programs become especially important during a credit crunch or economic downturn.

Unfortunately the data confirm that the credit market is tightening for small businesses. The January 2007 Federal Reserve *Senior Loan Officer Opinion Survey* found that credit standards for commercial and industrial loans to small businesses had tightened. Tighter credit standards mean small businesses that would have otherwise qualified for commercial loans no longer qualify.

Even more alarming is that SBA lending is not picking up the slack left by commercial banks by making more loans to small businesses as it has in prior economic downturns. Instead we are seeing an alarming decline in SBA 7(a) and SBA Express lending in Michigan and across the country. For instance, the number of 7(a) loans approved by SBA lenders decreased by about 18 percent in the second quarter of 2008 compared to the second quarter of 2007. In Michigan, based on loans made during the first six months of 2008, the number of 7(a) loans approved by SBA lenders appears to be down by about 35 percent, twice the national average.

Earlier this year, I met with SBA Administrator Preston specifically to discuss the need to enhance the SBA's credit programs in Michigan, and elsewhere, such as SBA's 7(a) loan guaranty program, as well as their microloan program. I encouraged SBA to use its existing programs to address the problems in states like Michigan that are suffering from high unemployment, job losses and high foreclosure rates.

I want to acknowledge recent SBA outreach efforts in Michigan. SBA's Detroit District office, in partnership with local and federal organizations, held two procurement conferences in Michigan. It held a women's procurement matchmaking event in Western Wayne County where more that 200 business owners and interested parties attended, and a small business workshop at Selfridge National Guard Base, where over 350 participants came to learn about federal procurement opportunities. I appreciate such efforts.

While this type of outreach is important, SBA has to do much more to reverse the decline in lenders making SBA loans. We can't have small businesses resorting to using credit cards with unreasonable terms and high interest rates or to other risky financing methods to finance their operations.

High fees might be one reason 7(a) loans are in decline. To address this, I joined Chairman Kerry and Senator Landrieu in introducing the Small Business Stimulus Act of 2008 which among other things would boost 7(a) loan activity by reducing lender and borrower fees charged by the SBA. I hope SBA will consider reducing fees, at least as a temporary measure.

I urge SBA to consider this idea and others and do all it can to make credit available to small businesses during the current economic downturn.

Senator John F. Kerry
Chairman, Committee on Small Business and Entrepreneurship
Hearing on
"The Impact of the Credit Crunch on Small Business"
April 16, 2008

Questions for the Record
For Cynthia Blankenship
Vice Chairman, Bank of the West;
Chair, Independent Community Bankers of America

- In your written testimony, you were critical of the SBA's decision to eliminate the Low Doc program. Why was LowDoc so important to community banks, and what businesses did it help that the current programs do not reach?

- Your written testimony also criticized the Administration for cutting the SBA's budget nearly in half over the past six years. Please explain in further detail how this decrease in funding has impacted community banks and their small business lending services.

Senate Committee on Small Business and Entrepreneurship
Hearing on the

The Impact of the Credit Crunch on Small Business
April 16, 2008

Q. Why was LowDoc program so important to community banks, and what businesses did it help that the current programs do not reach?

A. The Low Doc program was highly successful. The LowDoc program was an important program especially for community banks because it allowed them to deliver SBA loans in a straightforward and expedited manner. Notably, for community banks that processed only a few SBA loans per year, the LowDoc program offered a unique way to serve their community and vital to their participation in SBA lending. The paperwork in the typical SBA loan package is very burdensome and typically requires a highly-trained and specialized underwriter. Many community banks do not have the resources to have dedicated full-time SBA underwriters on staff. Therefore, the LowDoc program offered a smart alternative for community banks that were not PLP lenders to also participate in SBA lending in a reasonable way.

Many community banks have not chosen and can not afford to allocate the financial and labor resources that the standard SBA program requires. For that reason, the LowDoc program allowed many more banks to offer SBA loans to their customers because it was not as time intensive and burdensome. The bank could fund the loan to the customer on a much timelier basis. The LowDoc loan program allowed the banks to fund loans up to $100,000 using the expedited program without having to become Certified or Preferred lenders under the program, thereby creating access to the funds for small business owners.

The current SBA loan programs do not allow the banks the same access to SBA lending as LowDoc. Under the Rural Lender Advantage program, there are some advantages, but it is a very limited pilot program not widely available to all states and areas. After the termination of the LowDoc program, hundreds of community bank dropped out of SBA lending. This was especially true in rural areas where a few SBA loan go a long way in helping the local economy. Community bankers would welcome the restoration of the successful LowDoc program.

Q. The Administration has cut the SBA budget nearly in half over the past six years. Explain in further detail how this decrease in funding has impacted community banks and their business lending services.

A. By cutting the amount of SBA funds, the community banks have been disadvantaged because SBA fees have gone, new fees have been instituted, help from many SBA regional offices has diminished, and program like LowDoc have been terminated.

Additional SBA fees and cost shifting to the lenders and borrowers continue to be proposed. When something cost more your will get less of it.

Notably, higher fees and less local service have forced a greater concentration of SBA lending into the ten largest SBA lenders that can leverage their scale and volumes to offset the fees. As a result there are less SBA lenders serving fewer geographic regions of the nation. The smaller community banks have been challenged to make the SBA loan program efficient and affordable for both the bank and the borrower.

A key challenge has been to qualify the small business owner who cannot afford the higher up-front fees. We believe there should be some fee concession at this point in the economic cycle for consideration of lower fees and more funding to help stimulate needed beneficial small business creation and growth. A commitment to SBA lending to help small businesses means steady and reasonable program funding.

Senator John F. Kerry
Chairman, Committee on Small Business and Entrepreneurship
Hearing on
"The Impact of the Credit Crunch on Small Business"
April 16, 2008

Questions for the Record
For Professor Samuel Bornstein
Kean University

- In your testimony, you stressed the importance of financial literacy education for small business owners. Are there specific programs that you believe the SBA could utilize to help these owners improve their financial literacy?

- What role, if any, do you see lenders playing to help educate America's small business entrepreneurs?

Senator John F. Kerry
Chairman, Committee on Small Business and Entrepreneurship
Hearing on
"The Impact of the Credit Crunch on Small Business"
April 16, 2008

Response to Questions for the Record
Samuel D. Bornstein
Professor of Accounting and Taxation
School of Business, Kean University
May 23, 2008

Chairman Kerry, Ranking Member Snowe, and Members of the Committee. Thank you for giving me the opportunity to respond to your questions regarding financial literacy education programs for small business owners, which the SBA could utilize to help these owners improve their financial literacy; and the role that lenders can play to help educate America's small business owners. These topics are interrelated and touch upon other significant areas of concern.

Content of Response:

1) Delivery of Financial Literacy Education for Small Business Owners

2) Specific Programs that the SBA Could Utilize to Help Small Business Owners Improve Financial Literacy

3) The Small Business Owner Needs Personal Financial Literacy Education

4) The Role of Lenders in the Financial Literacy Education for Small Business Owners

5) Suggestion Which May Move Forward Proposed Legislation to Lower SBA Loan Fees

6) Solution to Overriding Problems: Economic Downturn, Subprime Mortgage Crisis, Homeowner Foreclosures, Bank Failure

Summary of Goals: Small Business Financial Literacy Education Program:

- Improve Small Business Management Skills
- Increase Small Business Owner Confidence
- Lower Small Business Failure
- Stimulate Lending
- Stimulate Job Creation
- Stimulate Economic Growth

Introduction

The topic of financial literacy education is being addressed in light of the Subprime Mortgage Crisis and the resulting liquidity turmoil and credit crunch which has been blamed for the devastating increase in personal and business defaults, foreclosures, and bankruptcies.

This crisis has precipitated a lack of confidence in the consumer, small business, and the lending community. The concern for loan default is the main element of risk that is the overwhelming force which is driving the restrictions placed on borrowing. A program of financial literacy education will stoke confidence and lower the level of risk which will stimulate lending, job creation, and economic growth.

There is a critical need for financial literacy education for small business owners, due to the high rate of small business failure and the disruption that follows. Financial literacy education will equip the small business owner with the knowledge to improve operating performance.

A Small Business Financial Education Program can provide education, training, and assistance to the small business community. The intent of the program is to deliver financial literacy education and to promote sustainable growth and economic development. To accomplish this goal, the program can be implemented through a partnership between the SBA and banking community.

The Small Business Owner is Directly Connected to the Subprime Mortgage Crisis

In my written testimony, it has been established that small business owners are part of the Subprime Mortgage Crisis. They used their homes as collateral for easy access to cash in the refinancing surge during the subprime mortgage era. Small business owners are at risk of the financial distress that will follow the resets of these mortgages, coupled with their continuing reliance on credit cards, and the uncertain and slowing economy.

It is a tragedy when individual homeowners lose their homes to foreclosure. We are now experiencing the devastating effect of these foreclosures on their neighborhoods, the community, and our economy.

But, when a small business owner is forced into foreclosure, not only does the owner suffer, but the employees also suffer. The pain is magnified across many unemployed households. It is essential that we recognize that we have a vested interest in the survival of small business to stimulate economic growth through job creation.

Response No. 1

Delivery of Financial Literacy Education for Small Business Owners

The Role of Financial Education

There is a schism between what we need to know and what we actually understand in our complex financial and credit-based economic environment. This is because, at least in part, we teach remarkably little about money and credit, and unfortunately, what is taught is often not understood.

Stated most simply, we live and deal with money daily, but may not understand and communicate effectively about it. The resulting education will change attitudes and behavior with respect to money choices.

In our discussion of financial literacy education for small business owners, there is much to be gained from the current assessment of traditional financial literacy education programs for high school and college students. The results indicate that traditional financial literacy education is not effective and failing in its mission to educate. These programs consist of formal classes, workshops, seminars, booklets, internet sites, etc.

Traditional financial literacy education programs merely disseminate financial literacy information, but ignore the main focus of education. Education involves learning and should promote cognitive change in the learner's ability to handle the challenging situations that may arise.

Traditional Financial Literacy Programs: A Vitamin Supplement to a Cancer Patient

Traditional financial literacy education programs have proven to be ineffective. These programs do not provide the knowledge and understanding to identify and address the specific and unique financial weaknesses of each individual small business. Traditional financial literacy programs are similar to giving a vitamin supplement to a cancer patient. Vitamin supplements are appropriate for prevention, but they are ineffective as a response to cure disease. The lack of financial management will result in small business failure.

Background

Artificial Intelligence & Intelligent Tutoring Systems Can Be Applied To Financial Literacy Education

A concept, known as Intelligent Tutoring Systems (ITS) or Intelligent Computer-Aided Instruction (ICAI), has been researched for more than three decades, resulting in operational ITS providing computer-based instruction. This technology can now be applied to financial literacy education.

Artificial Intelligence (AI) technology touches our lives on a daily basis. The GPS navigation system is a good example of how technology can communicate information. Research into the science of learning has enabled the development of ITS.

An AI based Virtual Tutor using ITS can help guide the understanding of financial literacy concepts. This technology provides small business owners and consumers with the knowledge, aptitude, and skills-base necessary to become questioning and informed consumers and manage their businesses and finances successfully.

Instead of being an information delivery system that bombards the learner with a large volume of information, which is typical in traditional financial literacy education, ITS customizes the instruction to match the level of knowledge and understanding of the learner. ITS guides the learner to a higher level of comprehension by providing explanations, hints, examples, demonstrations, and practice problems as needed. Research indicates that ITS-taught learners generally learn faster and translate the learning into improved performance better than classroom-trained participants.

Intelligent Tutoring Systems (ITS): One-on-One Tutoring

Research into the study of learning motivated the development of ITS and AI to use the computer to deliver the same level of guidance and instruction as a human teacher. This process is called One-on-One Tutoring.

In studies conducted in 1984, Dr. Benjamin S. Bloom noticed that only 2 percent of all the students receiving classroom instruction understood the material. They were classified as "smart" students. He discovered that any student given One-on-One "human" tutoring was able to attain a 2 grade level improvement, thereby being classified at the same level of knowledge and understanding as the so-called "smart students". Dr. Bloom defined this as the "two-sigma problem".

ITS Computer-based One-on-One Tutoring systems have been created and have attained comparable levels of learning as high as a 1.5 grade level improvement. Today, ITS have been used in various educational formats in the realm of corporate training, K-12 and college education, and military training simulations.

Why the Need for ITS to Deliver Financial Literacy Education?

Millions of dollars have been allotted to financial literacy education by the federal and state governments, businesses, banks, credit unions, and others. Financial literacy is now included, to at least some extent, in the educational standards of 40 states; 28 states require these standards to be implemented. An increasing number of states require students to take a financial literacy course as a high school graduation requirement.

The goal of education is to promote learning. Effective learning is accomplished when it promotes cognitive change in learners. Unfortunately, based upon the current assessment of these financial literacy programs, they are not fulfilling their mission. Learning, which is at the heart of education, is not taking place.

The 2006 National Jump$tart Coalition Survey: "Financial Literacy: Improving Education", made an assessment of the current state of financial literacy education:

"*We have long noted with dismay that students who take a high school course in personal finance tend to do a little worse on our exam than those who do not. This finding has been a great disappointment to consumer educators and to those who support efforts to make courses in personal finance a requirement for high school graduation. This leads to a conclusion that full-semester classes are not making our young adults more financially literate.*"

The apparent weaknesses in the traditional financial literacy education programs for high school seniors are borne out by numerous studies. In a study entitled...Financial Literacy: If It's So Important, Why Isn't It Improving? The study concluded: "*Measured financial literacy scores* *among high school seniors is low and has declined since 1997. Tracking students who took such a course over a 5 year period shows no positive impact on financial literacy."* [Mandell, 2006].

Response No. 2

Specific Programs that the SBA Could Utilize to Help Small Business Owners Improve Financial Literacy

My research has found evidence for the most effective model of a successful Small Business Financial Literacy Program which consists of financial education, technical assistance, and access to capital.

- **Financial Education: You Can't Manage if You Can't Measure**

  The knowledge of Practical Accounting enables small business owners to measure all the components of a business, such as assets, liabilities, revenues, and expenses. Business financial education should concentrate on teaching basic Practical Accounting skills and helping the business owner understand how these skills can be applied to solve problems and guide them to improve business management. The business owner is often bombarded by new and unfamiliar situations that require guidance. The owner should be aided in understanding the various tools that can help monitor and manage the business effectively.

- **Technical Assistance: SBA and Its National Network of Counselors**

  The SBA and its national network of counselors, such as SCORE, SBDC, Women's Business Centers (WBC), and SBA District Offices can be trained in all aspects of the Small Business Financial Literacy Education Program and can introduce it to the national small business community.

- **Access to Capital: The Lending Community**

  Capital is the lifeblood of small business. The lending community is the source of this lifeblood, and can play a significant role by providing easy access to capital. The Small Business Financial Literacy Education Program will reduce lending risk, increase lender confidence, stimulate lending, and boost economic growth.

The Specific Small Business Financial Literacy Education Program

- Teach Practical Accounting and its tools and techniques using ITS
- Diagnostic Small Business Financial Blood Test: An Early Warning System
- Interpret the Small Business Financial Blood Test Using Artificial Intelligence
- Provide a Virtual Tutor as a Self-Contained Advisor using ITS & One-on-One Tutoring
- Monitor periodically the Small Business Financial Blood to Stay On-Track
- Provide a Benchmark to Self-Monitor
- Interactive to Accept All Changes in Financial Position in Real-Time
- Accessible to millions: Web-Based, Interactive, One-on-One Tutoring, and User-Friendly
- Confidential: Can be Easily Accessed 24/7 in the Privacy of Home or Office

What is Practical Accounting?

Accounting is the language of business – the recording of all business transactions into financial statements that paint a financial picture of the business. Small businesses are especially vulnerable to problems that relate to inadequate accounting because they lack this vital prerequisite for small business management.

The knowledge of Practical Accounting is required to consistently and accurately record financial data that will provide reliable financial statements. Practical Accounting, and its tools and techniques, will provide the business owner indications of where the business has been, where it is, and where it is going.

The small business owner can and should be taught to analyze accounting and financial data, which could mean the difference between success and failure. The financial statements will be the source of accounting data to be used for the Small Business Financial Blood Test, which will help diagnose the business health and performance, and provide an early warning system to predict and correct problems before they damage the business.

Small business failure rates may be minimized by a program of Practical Accounting education and the Small Business Financial Blood Test which analyzes a business's accounting data and prepares a report using AI which interprets the business financial health.

Although this analysis is recognized as a valuable tool for business management, only two percent of businesses use it because of the difficulty in the interpretation of the results. AI is a most effective and efficient means to obtain an accurate interpretation without being limited by human error.

The Small Business Financial Blood Test: An Early Warning System

Businesses as well as individuals share the same concerns when it comes to health and survival. An individual's health can be monitored through blood tests, electrocardiograms, blood pressure readings, etc. The small business requires a unique health measurement mechanism, the Small Business Financial Blood Test, which can monitor its survival, profit, and growth.

The trend towards small business failure is highest within the first five years and is extremely critical to detect. Failure can be predicted and businesses can be saved by the Small Business Financial Blood Test as problems are detected in time for corrective action. Once the test indicates that certain needs are not being satisfied, the business owner can be alerted and take action to rectify the situation. The Small Business Financial Blood Test is an early warning indicator of business health.

With periodic usage, this test can measure the business performance by comparing against industry averages of similar sized firms. These industry averages are reported and offer a range of values between healthy and unhealthy. The Small Business Financial Blood Test Program can stimulate a better awareness of what it takes to be financially healthy and avoid the consequences of financial missteps.

What is Small Business Financial Blood?

How Can It Be Tested?

We annually monitor our personal health by going to the doctor and taking a blood test. The blood test is a personal health measurement mechanism which alerts the doctor to identify, diagnose, and cure any unexpected health problems. The blood test also provides a benchmark, by which the doctor can monitor our health and detect any future health problems in time for correction.

Let's say, you discover on your regularly scheduled annual physical check-up that your cholesterol level is 350, while it is recognized that any reading over 200 is viewed with concern. The doctor will prescribe a regimen of diet and exercise to help lower the cholesterol level. He will use the cholesterol level of 350 as a benchmark, and suggest periodic retests to measure the changes in the cholesterol level. These retests will determine whether the prescribed diet and exercise was lowering your cholesterol. This benchmark will guide your doctor to determine whether prescription medication would be necessary if your cholesterol level does not decrease.

The small business has its own unique Small Business Financial Blood, which can be tested. Small Business Financial Blood consists of assets, liabilities, revenues, and expenses. Research has proven that the Small Business Financial Blood can be tested in a manner similar to our personal blood.

Whereas our personal blood consists of 65 different aspects, researchers have identified as many as 16 different aspects of the Small Business Financial Blood that can provide an indication of the small business health. These tests identify the strengths and weaknesses of the business financial condition. By monitoring these aspects, we can create an early warning system which can diagnose and identify the weaknesses in the small business financial health.

Interpret the Small Business Financial Blood Test

Provide a Virtual Tutor as a Self-Contained Advisor: One-on-One Tutoring

AI will interpret the Small Business Financial Blood Test results and prepare a report, with color graphics, in simple language which the small business owner can understand.

ITS will provide a virtual tutor as a Self-Contained Advisor with One-on-One Tutoring to teach Practical Accounting and help guide the correction of the detected financial weaknesses in the Small Business Financial Blood Test.

The program will allow the input of changes in the small business's financial data, so that the owner can see how increases or decreases in revenues, expenses, assets, and liabilities, will affect the small business's total financial condition.

The Small Business Financial Blood Test Program offers an opportunity to enhance the financial literacy of the business owner. The program enables the owner to understand the implications of spending, debt and credit card usage, and other actions on the business's financial standing. The Small Business Financial Blood Test presents an independent and unbiased analysis of the financial health.

Response No. 3

The Small Business Owner Needs Personal Financial Literacy Education

In today's complex economic environment, the small business owner must meet the challenges of managing the small business and personal financial situation. This business owner's personal financial management is related to avoiding small business failure.

Since the small business requires access to capital for its cash flow needs, a healthy credit rating is vital for the business's ability to stay afloat. Personal financial literacy encompasses all aspects of personal money management which includes the knowledge of budgeting, spending, credit card usage, debt management, savings, insurance, retirement planning, etc. Financial literacy is essential to avoid personal and business financial distress which will have a negative impact on the FICO score.

The small business owner's personal and business financial literacy are intertwined and share the same education delivery system, which was described above. However, there are separate tools and techniques that are unique to each form of financial literacy.

The Personal Financial Literacy Education Program

- Teach Money Management using Intelligence Tutoring Systems (ITS)
- Diagnostic Personal Financial Blood Test: An Early Warning System
- Interpret the Personal Financial Blood Test Using Artificial Intelligence (AI)
- Provide a Virtual Tutor as a Self-Contained Advisor using ITS & One-on-One Tutoring
- Monitor periodically the Personal Financial Blood to stay on-track
- Provide a Benchmark to Self-Monitor
- Prevent Re-Default (Recidivism) After Initial Default & Loan Modification
- Accept all changes in Financial Position in Real-Time
- Interactive to Accept All Changes in Financial Position in Real-Time
- Accessible to millions: Web-Based, Interactive, and User-Friendly
- Confidential: Can be Easily Accessed 24/7 in the Privacy of Home or Office

The program of Personal Financial Literacy makes use of a Personal Financial Blood Test to analyze the financial health. The program will increase awareness of the implications of financial choices and is helpful for its predictive and diagnostic usefulness to prevent personal financial distress such as default, foreclosure, and bankruptcy.

Most Consumers are Financially "ill", and They Don't Even Know It.

The growth of spending, credit cards and other debt has been the cause of financial ruin for many consumers and small business owners. Most individuals are financially "ill", and they don't even know it. They may have spent or borrowed too much and may be at risk for financial insolvency. Considering that credit card debt is at the highest level and most consumers have resorted to making only the minimum payment on their credit cards, they may be on the verge of insolvency and not realize that they are slipping down the slippery slope towards bankruptcy.

Interpret the Personal Financial Blood Test

AI interprets the Personal Financial Blood Test and prepares a report, with color graphics, in simple language which the consumer can understand. This test monitors the financial health of the consumer and offers an independent and unbiased analysis of the personal financial situation.

AI accepts the input of financial data unique and specific to each individual consumer. It allows the input of changes in the consumer's financial data in real-time, so that the consumer can see how increases or decreases in income, expenses, assets, and liabilities, effect the total financial position.

This real-time and interactive component also offers an opportunity to enhance the financial literacy of the consumer by enabling the understanding of the implications of spending and credit card usage on the financial standing.

Provide a Virtual Tutor as a Self-Contained Advisor: One-on-One Tutoring

ITS will provide a Virtual Tutor as a Self-Contained Advisor with One-on-One Tutoring to teach the consumer money management and help guide the correction of the detected financial weaknesses in the Personal Financial Blood Test.

Personal Financial Literacy education cannot take a one-size-fits-all approach because the level of financial literacy understanding is not the same for all individual consumers. The unique quality of ITS is that this technology delivers education that is tailor-made to meet the specific needs of each learner. The technology invites the active involvement of the learner through the Virtual Tutor's one-on-one interaction and will stimulate interest for the pursuit of additional knowledge in financial literacy.

This technology will help guide the individual to an understanding of financial literacy and make a cognitive change in the ability to make the right decision and be financially literate in future financial decisions.

How does the Personal Financial Blood Test Work?

We annually monitor our personal health by going to the doctor and taking a blood test. The blood test helps the doctor predict and diagnose any health problems that we may not be aware of. Wouldn't it be nice, if we could also monitor our personal financial health by testing our financial blood? Research has proven that we can, by using a Personal Financial Blood Test.

With regard to the subprime borrower, the Personal Financial Blood Test Program will identify weaknesses and guide the borrower to avoid financial mistakes that would lead to delinquency and default. The Personal Financial Blood Test analyzes the financial status and stimulates an awareness of the implications of the borrower's actions on the financial health. Subsequent tests can be utilized as measurements of change in the financial progress over time.

The Personal Financial Blood Test Program can serve as a starting point for analysis and discussion of the consumer's financial well-being and can be used to help develop better credit use patterns, appropriate savings, investments, and will help reach financial goals. This is the main focus of an effective financial literacy education program.

Personal Financial Blood Test: Solution to the Subprime Mortgage Crisis

Subprime Borrowers -- Small Business Owners

There is an immediate need to help the subprime borrower avoid delinquency, default, and foreclosure. The subprime borrower is at risk of mortgage default in the upcoming round of mortgage resets that will be taking place over the next few years. The borrower should be given a Personal Financial Blood Test.

The Personal Financial Blood Test is a vital tool that can be used for immediate feedback on the financial health of the subprime borrower and can help guide this borrower to be capable of handling the mortgage payment. This program will identify areas in the borrower's personal financial situation that can be improved to avoid default.

Traditional foreclosure counseling, which is best performed one-on-one, is labor intensive and time consuming. The Personal Financial Blood Test Program is a web-based and confidential program easily accessible to all borrowers and can reach the millions at risk of losing their homes to foreclosure. In addition, subsequent tests can be utilized to help the borrower stay on-track as income and expenses change over time.

The main mistake that led to the Subprime Mortgage Crisis was that once the mortgage was made, the borrower was left to manage on-his-own. We all agree that we are living in a very complex financial environment with many enticements to use credit cards, incur debt, and spend freely. No one considered that this high risk borrower would require financial guidance. The result should have been expected.

Subprime Borrower: The Benefit of Financial Literacy Education

- Help Avoid Default
- Improve Borrower's Credit Rating
- Increase Consumer Confidence
- Increase Valuation of Subprime Mortgage Derivative Investments
- Increase Market Confidence
- Lower Write-offs on Subprime Mortgage Investments

Response No. 4

The Role of Lenders in Financial Literacy Education for Small Business Owners

Confidence is a driving force for economic growth. The lending community can play a pivotal role in efforts to increase confidence by addressing small business failure through their support of financial literacy education for small business. The small business owner needs confidence in the ability to survive and prosper, and the lending institutions need confidence in the small business owner in order to reduce the risk of default which will stimulate lending.

The Banking Community Has a Lot of Skin in This Game

Even Partial Success will Reap Significant Benefits

The most recent and comprehensive data on small business debt was reported in the Federal Reserve Bank's 1998 Survey of Small Business Finance. There was $700 billion in outstanding debt on the books of small businesses. Of that, $361 billion was supplied by banks, $86.5 billion represented loans from owners, and about $4.8 billion was credit card balances. More recent data would indicate growth in debt especially credit card debt.

Considering the size of the outstanding small business debt, and the fact that less than 40% of new businesses survive five or more years, we're talking about "real money." Even partial success will mean great savings both in money and the health and well-being of the economy.

The banking community has a lot of skin in this game, because of the negative impact when they are forced to write-off (charge-off) the resulting bad loans. For the fourth quarter of 2007, FDIC reported that the net charge-offs registered a sharp increase rising to $16.2 billion, compared to $8.5 billion in the fourth quarter of 2006.

In my testimony, it was established that small business owners were accessing capital through subprime mortgage loans and credit card debt. The FDIC reported that the Net charge-offs of residential mortgage loans were up by $1.3 billion (144.2 percent), and charge-offs of home equity lines of credit were $1.0 billion (378.4 percent) higher. Credit card charge-offs were up by $1.0 billion (33.0 percent), and charge-offs of other loans to individuals increased by $1.1 billion (58.4 percent).

By promoting Financial Literacy Education Programs for Small Business, the banking community can accomplish key goals:

- Financial literacy education qualifies for CRA compliance credit as a service to the community and can fit into any of the areas of CRA that are evaluated.

- The program can be an effective tool to attract prospective small business customers by offering them an opportunity to enhance their chances for success rather than fall victim to the high rate of small business failure.

- The banking community can offer this program to their existing customers to help them become more knowledgeable in managing their businesses. The program can also help lower the charge-off rate on bad loans and lead to more accurate and reliable financial statements for loan evaluations.

The Banking Community: Natural Partner to Help Educate Small Business Owners

The banking community has a vested interest in the success of their small business customers and should promote Small Business Financial Literacy Education. It is a natural partner to this effort as indicated by studies conducted by the Consumer Bankers Association (CBA) and the Board of Governors of the Federal Reserve System.

The need for Financial Literacy programs for small business was addressed in a report by the Consumer Bankers Association (CBA) entitled, "Financial Literacy Programs-A Survey of the Banking Industry". The CBA report emphasized the need for Small Business Financial Education.

"Although small business development is rarely considered in discussions regarding financial literacy, enhancing business owners' knowledge of financial and banking concepts is crucial. Such efforts help to produce financially sound businesses whose growth contributes to the economic well being of communities, particularly low-income communities."

Small Business Financial Statements Must Be Accurate & Reliable

Practical Accounting is of paramount importance in Small Business Financial Literacy Education and is a prerequisite for financial management. The accuracy of the financial information furnished by small business to the lending community is often questionable. This inaccuracy causes uncertainty and risk in any small business loan.

In the "Report to the Congress on the Availability of Credit to Small Businesses" prepared by the Board of Governors of the Federal Reserve System, small business failure was addressed as one of the risks of lending to small business. Small business lending is considered riskier and more costly than lending to larger firms. Small businesses are much more affected by swings in the economy and have a higher failure rate than larger firms. The report stressed the difficulty of obtaining reliable information to determine the creditworthiness of the small business due to the lack of accurate and reliable financial information often required by lenders in making underwriting decisions.

The cost to the lender continues beyond the decision to grant the loan. Lenders have to annually monitor the small business financial statements and depend upon their accuracy and reliability. The elevated costs of default risk and the ongoing costs of monitoring firm performance have made loans to small business less attractive for many lenders. The Small Business Financial Education Program will improve the accuracy and reliability of the financial statements and provide an element of confidence that the small business has attained the knowledge to avoid default.

Lending Community: The Immediate Benefit of the Small Business Financial Blood Test

The Small Business Financial Blood Test is the centerpiece of the diagnostic element in the Small Business Financial Literacy Education Program.

Whereas, the Practical Accounting education program is essential for the success of small business, the process of education takes time. The lending community and its existing small business customers can obtain an immediate benefit by implementing a Small Business Financial Blood Test Program to determine the financial health.

The lending institution depends upon the financial statements to get a picture of the operating performance of their existing customers. The Small Business Financial Blood Test Program offers an evaluation of the business liquidity, efficiency, and profitability and may be more significant than the actual sales and profit figures shown in the financial statements.

Lending Community: The Immediate Benefit of the Personal Financial Blood Test

The small business owner is also a consumer and is subject to all the challenges that impact the personal financial condition. With foreclosures accelerating and the real estate bubble deflating, many small business owners are facing a host of interrelated economic strains which can place them in a precarious situation.

Small business owners will benefit from the diagnostic Personal Financial Blood Test. The lending institution may also offer this test to their existing and prospective customers to help guide their successful passage through these treacherous economic waters.

Response No. 5

Suggestion Which May Move Forward Proposed Legislation to Lower SBA Loan Fees

Lower Default Risk -- Lower Costs

There is currently proposed legislation such as "Small Business Stimulus Act of 2008" and "Small Business Lending Stimulus Act of 2008" both sponsored by Senator John F. Kerry, along with other legislation to lower the borrower and lender fees in the SBA loan guaranty programs. The proposed legislation may be moved forward by the expectation that the program of financial literacy for small business will lower the small business failure rate and thereby lower the cost of default risk for both the SBA and lending institutions.

This approach would be similar to the discounted auto insurance premiums that students receive upon their completion of a safe driver's education course. Both the Small Business Financial Literacy Education Program and the safe driver's education course will lower the rate of failure and help lower the loss potential.

The cost of default risk is considered in the determination of SBA loan fees. While for the lender, the cost of default risk is considered in the interest rate which the lender charges the borrower. Everyone will benefit by a lowering of the small business failure rate, therefore it is beneficial to provide an incentive for the small business owner to complete the Small Business Financial Literacy Education Program.

The SBA can be a part of this effort by lowering or refunding the SBA loan fees upon the certified completion of the program. As the small business failure risk is lowered, these fees may be reduced or refunded, and the savings can be passed along to the small business owner. Lowering the default risk will lower the fees.

To qualify for this benefit, at the inception of the loan, the small business owner must make a commitment to complete the program. Once the small business owner presents proof of the successful completion of the program, these savings will accrue to the business owner's benefit.

The lending community can share in this effort by subsidizing the costs of the Small Business Financial Literacy Education Program because they will also benefit from lowering the risk of small business failure and the accompanying lower "charge-offs" on defaulted loans. The lenders can view this program cost as equivalent to an interest rate loan discount.

ANALYSIS OF COSTS & BENEFITS TO THE PARTIES

COSTS:

- **SBA** – Lower SBA Fees

- **Lending Institution** – Subsidizes the cost of the Small Business Financial Literacy Education Program for its small business customers.

- **Borrower** – Sweat Equity--Must complete the Small Business Financial Literacy Education Program.

BENEFITS:

- **SBA** – Lower small business failure rate will lower the risk of default on the SBA guaranteed loans.

- **Lending Institution** – Lower small business failure rate will lower the risk of default and reduce loan write-offs (charge-offs).

- **Borrower** – The program will result in a "smarter" small business owner:

  - Improve business management
  - Improve financial management which is recognized as the main cause of failure
  - Improve Personal Financial Literacy which will result in a "smarter" consumer
  - Lower risk of financial distress -- default, foreclosure, and bankruptcy
  - Maximize the small business's ability to survive and succeed

Response No. 6

Solution to Overriding Problems:

Economic Downturn, Subprime Mortgage Crisis, Homeowner Foreclosures, Bank Failure

Job creation is essential for economic growth. Although the $168 billion economic stimulus program was predicted to stimulate a half million new jobs, economists have recently concluded that the current rebates may not accomplish this goal.

Historically, small business has been a reliable source for job creation and can play a major role in an economic recovery. According to the Federal Bureau of Labor Statistics, in a nationwide survey, "employment at firms with fewer than five employees grew by 786,954 workers between 2001 and 2007, an 11.4 percent increase, while firms with more than 1,000 workers lost 1.2 million jobs during that time, a decline of 8.9 percent". The Small Business Financial Literacy Education Program will enhance small business's ability to fulfill its role as a job-creation engine.

The Subprime Mortgage Crisis & Credit Crunch

Although this hearing was called to address the impact of the credit crunch on small business, it should be recognized that this crisis has been driven by the Subprime Mortgage Crisis. This crisis has fulfilled the expectation and realization that subprime mortgages will default, derivative investments will lose value, securitization (the procedure that generates bank liquidity) will end, investments that were derived from subprime mortgages will take a nosedive, banks will write-off billions, and the economy will suffer a meltdown. Many recognize that we are now only in the first stages and the worst is yet to come. The Personal Financial Blood Test Program can be an effective diagnostic tool to guide the subprime borrower to avoid default, and it will mitigate the negative effects of this crisis.

Hope for Homeowners Act of 2008: Re-Default (Recidivism) Should be Addressed

Congress will soon be considering legislation, such as the "Hope for Homeowners Act of 2008", which will basically modify mortgages to save homeowners from foreclosure. It should be recognized that re-default (recidivism) is a matter of concern and should be considered as this legislation is structured.

Modification does not always work. Fitch Ratings reported that a good modification program may only have a 60-65 percent success rate. This implies that between 35-40 percent of borrowers will re-default on their loans within 12-24 months. Greg Lippmann, global head of ABS trading and syndicate at Deutsche Bank in New York, believes that modifying mortgages will only delay when the losses will occur, and that modifying mortgages that were delinquent doesn't mean that none of them would default. "Re-default (or recidivism) rates two years after a loan has been modified run between 30 percent and 50 percent, and that future re-defaults may be higher than the historical data suggest." The Personal Financial Blood Test Program is an effective tool to help borrowers to stay-on-track and avoid re-default on their mortgages.

One-on-One Foreclosure Counseling Can Be Effective, But...

A Joint Center for Housing Studies at Harvard University study commented on the rate of recidivism subsequent to one-on-one foreclosure counseling. The researchers found that approximately one quarter of borrowers who avoided foreclosure were delinquent again 12 months after counselor intervention, and about one third were delinquent again after 36 months (Cowan, Quercia, Moreno, 2004).

Re-defaults (recidivism) can be reduced with a program of counseling which involves budgeting, spending, and credit card controls. The most effective counseling for foreclosure prevention is one-on-one. But, there is a problem. One-on-one counseling is both labor intensive and time consuming. In my discussions with counseling services, they admitted that the borrower rarely returned for follow-up. Lacking financial literacy guidance, the borrower will soon revert to unbudgeted spending patterns and re-default.

The Personal Financial Blood Test Program may offer a solution using Artificial Intelligence, Intelligence Tutoring Systems, and web-based One-on-One Tutoring. It will provide confidential one-on-one foreclosure counseling in the privacy of the borrower's home or office and can reach millions of borrowers, anytime and anywhere.

Half of Debtors in Bankruptcy were Homeowners

A study found that more than half of a sample of 1,500 debtors in bankruptcy was homeowners, and over half owned their homes for five years or less. This was noted in the largest empirical study of consumer bankruptcy in the U.S. (Sullivan, Warren, Westbrook, 1989). Homeowner bankruptcy may have been due to a number of factors; nevertheless, the knowledge of financial literacy could have saved a substantial portion. The study found that although these homeowners previously qualified for their mortgages at inception, they were vulnerable for delinquency because they were generally lacking the basic understanding of how to manage their finances.

The Personal Financial Blood Test Program offers one-on-one interactive counseling that can be effective to prevent re-default.

Bank Failure: Correlation Between Small Business Failure and Bank Failure

The FDIC, OCC, Federal Reserve Bank, and others are expecting an increase in bank failures, and they are preparing for this eventuality. In my testimony, I referred to a research study conducted by the Federal Reserve Bank of Cleveland which found a correlation between small business failure and bank failure.

Bank failure and its relation to small business failure suggest that addressing small business failure should be a priority. These bank failures will further reduce the availability of capital for our financial system. According to Joseph Mason, the Drexel professor, bank failures don't cause recessions, they lengthen them. The recession can be mild or it can linger and worsen as a result of the inability to circulate capital in the banking and financial system.

Conclusion

The Subprime Mortgage Crisis can be blamed for the credit crunch due to uncertainty and the high risk of default. Small business owners, who tapped into the equity in their homes for cash to fund their businesses, are included in the ranks of the millions of homeowners who may lose their homes to foreclosure.

The credit crunch is only a symptom of the disease. The inherent disease must be cured. This crisis can be turned-around by instilling confidence in the small business owner's ability to survive and succeed, the homeowner's ability to avoid default and foreclosure, and the banking and investment community to provide access to capital on the road to recovery.

The Small Business Financial Literacy Education Program will proactively address small business failure in partnership with the SBA and the lending community. This program will increase lender confidence, stimulate lending, and promote job creation. Even partial success will lower the small business failure rate and impart confidence throughout the economic system.

The Small Business and Personal Financial Blood Test Programs can provide ongoing guidance for small business owners, homeowners, and consumers. Due to the imminent risk of foreclosure on millions of homeowners, the Personal Financial Blood Test will provide immediate guidance to avoid losing their homes, both now and in the future.

The Personal Financial Blood Test Program will provide guidance to homeowners, which can be applied to any modification instituted by legislation to forestall foreclosure and prevent re-default. This crisis offers a unique opportunity to institute specific financial literacy education programs to lead out of this economic quagmire.

Senator John F. Kerry
Chairman, Committee on Small Business and Entrepreneurship
Hearing on
"Impact of the Credit Crunch on Small Business"
April 16, 2008

Questions for the Record
For Marilyn Landis
President, Basic Business Concepts;
Chair, National Small Business Association

- **In your written testimony, you listed specific actions that Congress could take to help reform some credit card industry practices. Which of those actions do you believe are most important to helping the small businesses that rely upon credit cards for financing?**

Prohibiting—or, at least, greatly restricting—the ability of the credit card industry to retroactively raise consumers' interest rates probably is the single most important action that Congress could take to help the small businesses that rely on credit cards. One of the basic tenets of free-market capitalism is the sanctity and insolubility of contracts, but somehow the credit-card industry has managed to insulate itself from adherence to this principle, retaining the right to unilaterally change the conditions of their contracts at any time. The retroactive application of penalty interest rates effectively increases the purchase price of products and services for which consumers are already committed. This *ex post facto* application undermines business plans and creates economic havoc on America's small businesses.

Limiting the interest rate percentage increases that card issuers can impose on cardholders also would be greatly beneficial to small businesses. Having an interest rate rise from, say, 15 percent to the average default rate of 27.3 percent because of one late payment or slightly exceeding one's credit limit seems an awfully stiff penalty and is extremely detrimental to the entrepreneurs that rely on credit cards to finance their small firms.

On a similar vein, requiring card issuers to apply customers' payments to their card balances with the highest interest rate first rather than the lowest, which is common practice now, also would be greatly beneficial to America's small-business owners.

It is important to note that if a small-business owner has a card with an interest rate that jumps to 27.3 percent because of some infraction—real or perceived—the solution is not as easy as simply going out and getting a new card. Each credit card inquiry, let alone application, affects one's credit score, which affects the interest rate one is going to be offered.

- **In the next NSBA survey, will it be possible to find out how many small business owners have used, or are currently using, home equity loans to finance their small business operations?**

According to the 2008 NSBA National Survey, 10 percent of small-business owners leveraged their business loans with a second mortgage, and 18 percent of the small-business owners with business loans leveraged them with a second mortgage.

It is important to note, however, that these figures probably only represent the percentage of small-business owners *currently* using home equity loans to finance their firms. It is likely that a much higher percentage of small-business owners have relied on home equity loans at some point during their various stages of growth. NSBA will attempt to gain a more nuanced understanding of how many small businesses have used home equity loans at some point in their next survey of small- and mid- sized businesses.

Responses to Questions for the Record
"The Impact of the Credit Crunch on Small Businesses"
Mr. Bob Mitchell, Witness

Q. In your testimony, you indicated that, like many other small business owners, you want to borrow money to grow your business but banks will not give you a loan despite your firm's solid track record. The SBA and Administration officials say that small business lending is down because there is far less demand for the loans than there was two or three years ago. Do you agree that the drop in demand is the primary reason for the reduction in small business lending?

A. When addressing the primary reason for reduction in demand, I believe it could be factually substantiated that new loan demand in my industry (housing) is virtually non-existent. However, there are existing loans that necessarily need to be extended with some modifications in terms to allow the debtor the needed time to meet the obligation. There is great difficulty in qualifying for new loans, but there is greater need for cooperation and forbearance from lenders so that borrowers can pay off current debt.

Q. Since the hearing, have you made any significant progress in obtaining adequate financing for your business? To what do you attribute that progress (or lack thereof)?

A. Since the hearing in April, credit conditions have progressively worsened. Lenders are concerned about liquidity, and the terms of the loan - if the discussion ever gets that far - are most likely not possible for the borrower to accept. The lender's position is that a loan was offered but, in practicality, it was with foregone knowledge that the borrower did not have the ability to accept the terms.

Thus, I have not made progress in obtaining the financing, new or renewal, due to the widespread problems of liquidity at all levels of financial institutions.

Governor Frederic Mishkin subsequently submitted the following in response to a written question received from Chairman Kerry in connection with the April 16, 2008, hearing on "The Impact of the Credit Crunch on Small Business":

During your oral testimony, you indicated that you could not comment on the April 2008 Federal Reserve Senior Loan Officer Opinion Survey. Since that survey will likely have been released before you respond to the Committee's questions for the record, please comment on the results of the April 2008 survey and what they say about the current state of the small business credit market.

In the April Senior Loan Officer Opinion Survey, domestic and foreign banking institutions reported having further tightened their lending standards and terms on a broad range of loan categories, including business loans, over the previous three months. The net fractions of domestic banks reporting tighter lending standards were close to, or above, historical highs for nearly all loan categories in the survey.

About 55 percent of domestic banks--up from about 30 percent in the January survey--reported tightening lending standards on C&I loans to large and middle-market firms over the past three months. Significant majorities of respondents reported tightening price terms on C&I loans to these firms, and in particular, on net, about 70 percent of banks--up from about 45 percent in the January survey--indicated that they had increased spreads of loan rates over their cost of funds. In addition, smaller but significant net fractions of domestic banks reported tightening non-price-related terms on C&I loans to these firms over the past three months.

Regarding C&I loans to small firms, about 50 percent of domestic respondents reported tightening their lending standards on such loans over the survey period, compared with about 30 percent who reported doing so in the January survey. On net, about 65 percent of banks--up from about 40 percent in the January survey--also noted that they had increased spreads of C&I loan rates over their cost of funds for these firms. In addition, large net fractions of domestic respondents reported tightening other price-related terms, and smaller fractions tightened non-price-related terms on C&I loans to small firms.

Although the April Senior Loan Officer Opinion Survey shows that banks, on net, continued to tighten lending standards, the available data overall do not suggest that small businesses are in a severe credit crunch. In particular, recent surveys by the National Federation of Independent Business (NFIB) show that the net percent of small businesses that found credit more difficult to obtain over the past three months has generally been well below its highs in the early 1990s. NFIB surveys also show that only a small fraction of borrowers identify credit access as their most important problem.

Governor Frederic Mishkin subsequently submitted the following in response to written questions received from Senator Snowe in connection with the April 16, 2008, hearing on "The Impact of the Credit Crunch on Small Business":

1. How have the Federal Reserve's recent actions helped to increase the pool of capital available to small businesses?

Over the past year, the Federal Reserve has instituted several innovative measures to ease liquidity pressures in inter-bank funding markets. These actions should help reduce strains on banks and so encourage them to deploy their capital to support lending, including lending to small businesses. In addition, we have strongly encouraged banks to raise capital, and some have already done so. The Federal Reserve has also reduced the target federal funds rate by a total of 325 basis points, which should spur economic activity over time, and in doing so increase banks' willingness to lend to small businesses. The reductions in the target federal funds rate appear to have reduced small-business funding costs. The average short-term interest rate paid by borrowers in a survey conducted by the National Federation of Independent Business (NFIB) fell about 130 basis points over the past year.

2. What else can the Federal Reserve do to ensure that small firms have the capital they need to create new jobs, products, and opportunities during these challenging times?

The Federal Reserve will continue to monitor financial conditions closely and will continue to take action, as appropriate, in response to future developments in these markets. The Fed will also continue to encourage banks to ensure that they have ample capital on hand. In addition, the Federal Reserve will continue to use monetary policy in pursuit of its dual mandate of maximum sustainable employment and price stability.

3. How will the Federal Reserve's actions serve to increase or decrease the duration of this liquidity crisis for small firms?

The answers to questions 1 and 2 summarize my views on the steps that the Federal Reserve has taken and will take in the future to ameliorate the effects of financial turmoil.

4. Are there any additional policies that the Federal Reserve recommends that Congress consider to either boost the economy or smooth the functioning of credit markets?

In testimony before the Joint Economic Committee on April 2nd, Chairman Bernanke noted the central importance of housing to the current economic situation and encouraged the Congress to seriously consider action in a number of related areas. Specifically, in response to a question from Senator Schumer, Chairman Bernanke said: "I do think Congress needs to be looking at housing. I think it is the center of the situation, the center of the problem at this point. I do think that strengthening the FHA, strengthening GSEs to do their mission, those are all constructive things, and I hope Congress will address housing issues going forward."

5. There seems to be debate as to whether the credit crunch is impacting small businesses. On the one hand, the Federal Reserve's January 2008 Senior Loan Officer Opinion Survey suggests that credit is more difficult for small businesses to obtain. On the other hand, the April 2008 National Federation of Independent Business' Small Business Economic Trends survey concludes, "For the eight straight month since the Federal Reserve declared the existence of a 'credit crunch,' no evidence of credit problems has appeared on Main Street." What is your view regarding small businesses experiencing a credit crunch? How should the Senate Small Business Committee interpret conflicting statistics and opinions about whether small businesses are undergoing a credit crunch?

On balance, the data do not suggest small businesses are in a severe credit crunch. On the one hand, the April Senior Loan Officer Opinion Survey (SLOOS) shows that banks, on net, continued to tighten lending standards. On the other hand, recent NFIB surveys show that the net percent of small businesses that found credit more difficult to obtain over the past three months has generally been well below its highs in the early 1990s. NFIB surveys also show that only a small fraction of borrowers identify credit access as their most important problem.

To interpret the data, it is helpful to keep in mind that the tightening of lending standards reported in the SLOOS does not necessarily imply a credit crunch. Tighter lending standards may indicate that loans have become riskier, not that banks are unwilling to make loans to profitable businesses.

6. Battered by the punishing housing slump, the high price of gasoline, and other factors, the economy has grown at an anemic 0.6 percent pace during both the first quarter of 2008 and the fourth quarter of 2007. In February, Congress passed the Economic Stimulus Act of 2008 that, as its centerpiece, authorized tax rebate checks. Hopefully, these checks will add to economic growth during the second half of the year. With that as background, what is the Federal Reserve's latest analysis of where the economy currently stands? Is the Federal Reserve currently forecasting a recession?

The Minutes for the meeting that was held on April 29th and 30th report that at that meeting, participants "noted that the data received since the March FOMC meeting, while pointing to continued weakness in economic activity, had been broadly consistent with their expectations... Economic activity was anticipated to be weakest over the next few months, with many participants judging that real GDP was likely to contract slightly in the first half of 2008. GDP growth was expected to begin to recover in the second half of this year, supported by accommodative monetary policy and fiscal stimulus, and to increase further in 2009 and 2010. Views varied about the likely pace and vigor of the recovery through 2009, although all participants projected GDP growth to be at or above trend in 2010." The Federal Reserve has not taken a position on whether the current economic situation meets the technical definition of a recession. That determination will be made by the National Bureau of Economic Research in Cambridge, MA.

Senator John F. Kerry
Chairman, Committee on Small Business & Entrepreneurship
Hearing on
"The Impact of the Credit Crunch on Small Business"
April 16, 2008

Questions for the Record
For Secretary Daniel O'Connell
Executive Office of Housing and Economic Development
Commonwealth of Massachusetts

Question 1—
At the hearing, you indicated that, although very similar to the SBA's 7(a) loan program, the Massachusetts Small Business Capital Access Program charges fees that are approximately one-third of the 7(a) fees charged by the SBA. Why do you believe this disparity exists?

Answer 1—
The disparity exists due to the way the programs are structured, both via their fees and the amount or work required to obtain the guarantee. The Massachusetts Small Business Capital Access Program's (CAP) fees to the borrower average approximately 3% of the loan amount which is slightly less than the SBA's for loans in the $150,000 to $700,000 range. CAP's fee is one time, paid at the loan closing. For loans that exceed $700,000, the SBA's fees increase; they also charge a servicing fee for each year the loan is open, so over the life of the loan, their cumulative fees to the borrower can be significantly higher than those of CAP.

Accessing the CAP program is very simple and requires no extra work on the part of the borrower; there is no application form to fill out. When a business applies to a participating bank for a commercial loan, the bank will determine if the loan requires credit enhancement and then submit an enrollment form to CAP. The enrollment form is less than a page in length and the bank negotiates all loan terms with the borrower directly, including pricing and the level of guaranty premiums required. It is also the bank that commits and funds the loan, following its own procedures within its own timeframe. The borrower only has to deal with his/her bank thus making the process very simple and easy.

Question 2—
Last January, foreclosures in Massachusetts were up 128% from the previous year. The foreclosure rates of five Massachusetts metro areas are in the nation's top 100. how is the recent increase in foreclosures affecting access to credit for small businesses in Massachusetts?

Answer 2—
The increasing pace of foreclosures is not directly affecting access to credit for small businesses in Massachusetts, although the indirect effects are significant. In fact, many lenders are currently shifting their lending strategies towards commercial lending to compensate for the slowdown in residential real estate lending activity. Nevertheless, small businesses are being adversely impacted by the foreclosure crisis in a number of significant indirect ways.

First, many small business owners rely on the equity in their homes to fund both start-up and operational costs associated with their businesses. However, as real estate values continue their downward trend throughout Massachusetts, the amount of home equity available to small business owners is rapidly disappearing and the absence of this funding source can severely hinder their ability to operate as a going concern. Second, some lenders are tightening their loan underwriting standards as they face mounting losses and are much less willing to risk lending their funds to any borrower that shows even the slightest degree of repayment risk. As a result, the overall availability of credit to small businesses is tightening and is threatening the viability of some higher risk small businesses that rely on credit to fund their daily operations. Third, the economic challenges facing Massachusetts and their impact on consumer confidence have led to a general slowdown in both personal and business spending. Unfortunately, this slowdown in spending is severely impacting small businesses across all sectors of the Massachusetts economy in the form of slower or even negative revenue growth. As small businesses struggle to maintain profitability, job losses usually result.

The net effect of all of these factors is that while the foreclosure crisis in Massachusetts does not impact access to credit by small businesses directly, the cumulative effect of the above economic factors has created a tenuous environment within which they must operate successfully. As the situation worsens and financial performance deteriorates, many small business owners are seeing their access to credit severely limited if not curtailed entirely until the Massachusetts economy and local real estate values recover.

Questions for the Record

KERRY Questions

1. **At a previous Committee hearing, you said that the SBA was embarking on a "nationwide campaign to meet with senior members of the larger banks" to try to reverse the downward trends in SBA lending. Please provide a list of the lenders with whom you and/or other SBA representatives met during that outreach campaign.**

Answer
In the past several months, SBA has embarked upon a series of events to reach out to SBA lenders of all sizes to ascertain the availability of credit for small businesses. The exact discussion topics differed with each roundtable based on the concerns of the lenders in attendance. Typical items discussed included: the current credit conditions and availability of credit for small businesses; demand for credit by small businesses; the degree to which credit standards were being expanded or contracted or left unchanged; use of SBA loan products; and feedback on SBA's customer service and streamlining efforts.

SBA representatives, included the Administrator and senior representatives of the Office of Capital Access, have met individually with lenders to discuss strategies and the environment for small business lending, their SBA lending activities and SBA's customer service and responsiveness.

These events include the following roundtables:

New York Roundtable, December 20, 2007
Citibank
Bank of America
Flushing Savings Bank
JPMorgan Chase
Empire CDC/NYBDC
United Commercial Bank
Commerce Bank
LIDC/Greater NY Dev. Corp.
Business Initiative Corp.
Banco Popular
BNB Bank
HSBC Bank USA
CIT Small Business Lending
Manufacturers and Traders Trust
SHB America Bank
RBS Citizens
Valley National Bank
China Trust

Community Building Fund
New Bank
PNC Bank

Salt Lake City Roundtable, January 17, 2008
First Utah Bank
Zions First National Bank
Central Bank
Popular Small Business Capital
First Federal Credit Union
First Utah Bank

Denver Roundtable, January 23, 2008
United Western Bank
Community South Bank
Colorado Lending Source
US Bank
Small Business Consultant
Vectra Bank
Preferred Lending Partners (CDC)

Denver Roundtable, February 26, 2008
CEDCO CDC
Colorado Lending Source CDC
Community Bank South
US Bank
Colorado Lending Source
Wells Fargo Bank
Vectra Bank
UPS Capital
United Western Bank
Bank the West
Collegiate Peaks Bank
Colorado Enterprise
Matrix Bancorp
Compass Bank
First Southwest Bank
American National Bank
First Heritage Capital
Guaranty Bank
Community West Bank
Money Dynamics
Wachovia
Iron Stone Bank

Washington, DC Roundtable, March 5, 2008
Zions Bank
National City Bank
Bank of America
US Bank
Banco Popular
Wachovia
JP Morgan Chase
Wells Fargo
CIT
Citi
BB&T

Rhode Island Roundtable, March 28, 2008
Sovereign Bank New England
Navigant Credit Union
Independence Bank
BankRI
The Washington Trust Company
Navigant Credit Union
Coastway Credit Union
Coventry Credit Union
Citizens Bank
Business Development Company of Rhode Island
Greenwood Credit Union
BankNewport
Bank of America
Westerly Community Credit Union
Citizens Financial Group
Bank of America
NewportFed
Freedom National Bank
Ocean State Business Development Authority
Home Loan and Investment Bank
Coastway Credit Union
Webster Bank
Coventry Credit Union
Navigant Credit Union
BankRI
Webster Bank
Westerly Community Credit Union

San Francisco Roundtable, April 01, 2008

Bank of America, NA

Wells Fargo Bank, NA
TMC Development Corp.
Bay Area Development Co.
Capital Access Group
EDF Resource Capital, Inc.
Heritage Bank of Commerce
Comerica Bank
Superior Financial Group
First Community Bank
Sterling Savings Bank
California Statewide CDC
First Nat. Bank of No. Calif.
Calif. Coastal Rural Dev.

Los Angeles Roundtable, April 03, 2008
First Private Bank & Trust
Alliance Bank
Wilshire State Bank
Valley Economic Development Center
Nara Bank
Innovative Bank
Banco Popular North America
Americas United Bank
California Statewide Certified Development Corporation (CDC)
CDC Small Business Finance Corporation
Bank of America
Beach Business Bank
Banco Buena Ventura
Stultz Financial Inc.
Pacific Coast Regional Development Small Business Corporation
Excel National Bank
CEDLI
Wachovia Small Business Capital
Celtic Bank
PromericaBank
First Standard Bank
J.R. Bruno & Associates
Comerica Bank
California National Bank
United Pacific Bank
US Bank
Community West Bank

Boston, Roundtable, April 08, 2008
Bay Colony Development Company
Southeastern Economic Development Corporation

New England Certified Development Company
Kaznoski, Eastern Bank
Middlesex Savings Bank
Bank Five
Metro Credit Union
Century Bank
Sovereign Bank
Enterprise Bank
Citizens Bank
Webster Bank
NewAlliance Bank
CT Community Investment Corp.
Housatonic Industrial Development Corp.
Northway Bank
Granite State Economic Development Corp.
Laconia Savings Bank
New Jersey Business Finance Corp.
TD Banknorth

Philadelphia Roundtable, April 09, 2008
Business Finance Group
Commerce Bank
Commerce Bank Harrisburg
Continental Bank
Delval
Hopewell Valley Community
Mid-Atlantic Business
Penn Liberty Bank
PNC Bank
Royal Bank
SBFG
Seda Cog
Seedco
Starfield and Payne
Stonebridge
Susquehanna Bank
The Bank
Unity Bank
Wachovia

Atlanta Roundtable, April 15, 2008
One Georgia Bank
Capital City Bank and Trust
UPS Capital
Fidelity Bank
Metro Bank

CSRA Business Lending (CDC)
Georgia Certified Development Corporation (CDC)
Small Business Assistance Corporation (CDC)
Georgia Resource Capital (CDC)
Georgia Small Business Lender, Inc. (CDC)
DeKalb Enterprise Business Corporation (Microlender)
Capital Partners Certified Development Company (CDC)
Omni National Bank
Haven Trust Bank
SunTrust Bank
Coastal Area District Development Authority (CDC)

Dallas Roundtable, April 16, 2008
JP Morgan Chase Bank
Bank of America
Compass Bank
Wells Fargo Bank
CIT Small Business Lending
Comerica
Prosper Bank
Capital One Bank
Millennium State Bank of Texas
Southwest Securities
Community Bank
NARA Bank
Amegy Bank
Mainstreet Lenders
North Texas CDC
Greater East Texas CDC
Fort Worth Econ. Dev. Corp
Banco Popular
Colonial Savings
United Central Bank
1st. National Bank
Citizens National Bank of Texas
One World Bank
Washington Mutual Bank
Sterling Bank
CDC Mt. West Mall
First Community Bank of Central Texas
Texans Credit Union
PMC Commercial Trust
Frost Bank
UPS Capital
Woodforest National Bank
Small Business Loan Source

Kansas City Roundtable, April 17, 2008
Commerce Bank
Douglass County Bank
Summit Bank of Kansas City
UMB Bank, N.A.
Liberty Bank
Empire Bank
CIT Small Business Lending
Labette Bank
Mazuma Credit Union
Bank of Missouri
Heartland Business Capital Inc.
RMI
Brotherhood Bank
US Bank

Chicago Roundtable, April 18, 2008
Busey Bank
Banco Popular
Marine Bank
Heartland Bank
National City
Harris Bank
SomerCor 504
First American Bank
National City
Enterprise Bank

2. **In early March, you attended a closed-door meeting at the White House with various bank representatives and senior member of the Bush Administration. Please provide the Committee with a list of the attendees and a description of the topics covered at the meeting.**

Answer
Please see the response to Question #1 for a list of attendees at the Washington, DC roundtable.

3. **In your testimony at the Committee's budget hearing earlier this year, you said that five banks made up 100 percent of the decline in the 7(a) program. Since that hearing, 7(a) lending continues to decline. Please update the Committee on the situation with those five banks, as well as any others that you are experiencing significant reductions in 7(a) loans.**

Answer:
Through the end of April, overall 7(a) lending is down 18% and SBAExpress lending is down 30%, but collectively the five largest lenders are off more than 56% overall and 78% in SBAExpress Lending. Overall, we are down 10,800 loans; 9,000 are from these five lenders. Three of these five lenders had higher risk ratings and were encouraged by SBA through its oversight efforts to tighten their credit standards.

4. **There have been concerns that CIT, a large SBA lender, has experienced liquidity problems. What, if any, outreach efforts has the SBA made to ensure that CIT continues to be a productive SBA lender?**

Answer
As part of the lender relationship and marketing effort described above, CIT has an assigned relationship manager. There has also been contact with senior agency officials and top officials at CIT. SBA monitors the situation with CIT and maintains an ongoing dialogue on issues relevant to the SBA unit within CIT. As a general matter, a steady flow of funds through securitizing of SBA loans can help prevent a capital crunch within a 7(a) lender.

5. **During your state of the agency address in January, you indicated that fee reductions on 7(a) loans were not necessary because the Fed had already cut interest rates, making loans more affordable for borrowers. The Fed has now cut the funds rate six times since September 2007, with the most aggressive cut in January. Please explain why 7(a) lending continues to decline despite the numerous rate cuts.**

Answer:
In talking to lenders we heard that factors influencing the decline in 7(a) lending include current economic conditions. We have noted three trends: The demand for small business loans has declined, borrowers are on the whole less creditworthy, and some lenders have tightened their credit standards. As a reflection of these trends – primarily lower demand but also tighter credit – SBA has seen a decline in our own loan-guarantee volume.

Lower demand is one response to generally sluggish economic conditions, as confidence in the economy is particularly important for small businesses. The Federal Reserve's April 2008 Senior Loan Officer Survey shows 15 percent of large banks and 20 percent of small domestic banks saw weaker demand for loans from small firms.

At the same time, we are seeing a tightening of credit standards by many lenders. According to the Fed's recently released April 2008 Senior Loan Officer Survey, about 50 percent of lenders reported tightening their lending standards on business loans to small firms. That compares to about 30 percent of lenders who reported tightening standards on these loans in January.

6. **The Greatest decline in 7(a) lending is the Express program, the program that has grown the most in the last few years. The Committee has been told that some banks have backed away from the product because they fear that SBA will refuse to pay the guarantee on a defaulted loan during these uncertain economic times. Does the SBA believe that this is a legitimate concern?**

Answer:
No. The decline in loan volume is largely due to a decline in the number of Express loans made. SBA is seeing a shift from smaller loans with a guarantee of 50% to larger loan sizes with higher guarantees. Lenders have indicated to us that they had pushed the credit envelope too far when approving these high volumes of Express loans and that part of the decline is accounted for by appropriate tightening of their standards in this area. We have not heard from lenders that they are concerned about SBA paying on the guarantee on Express Program loans. The guarantee is backed by the full faith and credit of the United States Government, and SBA will continue to pay the guarantee claims on all valid loan guarantee commitments regardless of what happens in the economy.

SNOWE Questions

1. **What is the SBA's concrete plan to address the impact of the liquidity crisis on small firms that are struggling to obtain capital during these tough economic times?**

Answer:
The flow of capital between banks and small business borrowers is critical for economic growth. SBA is working diligently with lenders to ensure that much needed capital is available to small business owners during these times when they most need help. Toward this end, in recent months we have held roundtables around the country in cities including Atlanta, Georgia; Boston, Massachusetts; Chicago, Illinois; Dallas, Texas; Denver, Colorado; Kansas City, Missouri; Los Angeles, California; Philadelphia, Pennsylvania; San Francisco, California; Washington, D.C; and New York, New York as well as individual meetings around the country with hundreds of lenders to review their strategies and the quality of their portfolios, and to support their use of SBA products to reach small businesses. These sessions have given SBA the opportunity to both articulate the value of SBA's guarantee to lenders and discuss with lenders issues of concern to them. We are also working to streamline our processes and have released a new, more user-friendly SOP 50 10. At the same time, we have developed a 7(a) initiative for small community and rural-based lenders that makes it easier for these banks to work with SBA.

2. **How is the SBA simplifying the paperwork for small business borrowers, or finding creative ways to reduce costs and fees, so that small firms can access the loans they need during this liquidity crisis?**

Answer:
We are working very hard to improve our processes so that we are better, more responsive partners for our lenders. And we are offering new services and processes that will encourage more lenders to use them. Because the SBA process are more efficient, small business borrowers will end up benefiting through reduced requirements placed on them by SBA lending partners.

We are working to streamline our process for lenders making it faster, easier, and cheaper for lenders to use our products. Centralization of some agency functions has also improved processes. We have worked to address issues in our processing centers and engaged in strategic planning to better forecast and understand volume.

We are also leveraging technology to improve the way we deliver our services and to provide lenders with responsive and helpful service. With E-Tran, we have leveraged technology to accept purchase packages electronically, making the process quicker, easier and less expensive for lenders. E-Tran is also available to lenders for loan origination and servicing. At the same time, we are making things easier by modernizing our SOP 50 10, making it shorter, up to date, and more user-friendly for lenders.

SBA is also continuing to introduce a new 7(a) loan initiative designed to meet the unique loan processing needs of small community/rural-based lenders, many of which do not currently make SBA loans or make very few SBA loans. Small/Rural Lender Advantage is designed to encourage small community/rural lenders to partner with SBA by simplifying and streamlining the Agency's application process and procedures, particularly for smaller SBA loans.

In addition to these changes that help lenders work with SBA are savings that are ultimately passed off to borrowers, we are working closely with our national network of resource partners to ensure that borrowers are able to access the resources they need. SBA also recently released two new online courses to directly provide borrowers with information to help them better understand and navigate the process for funding their small businesses.

3. **Does the SBA have a plan to immediately increase the number of participating lenders so that more small firms are able to access SBA loans through their local lenders?**

Answer:
As part of our overall marketing strategy, SBA is reaching out to potential lenders to talk about how our products might help small businesses in their communities. SBA is continuing to introduce a new 7(a) loan initiative designed to meet the unique loan processing needs of small community/rural-based lenders, many of which do not make

SBA loans or make very few SBA loans. Small/Rural Lender Advantage is designed to encourage small community/rural lenders to partner with SBA by simplifying and streamlining the Agency's application process and procedures, particularly for smaller SBA loans. SBA introduced Small/Rural Lender Advantage on January 8, 2008, in its Region VIII and is now moving to extend Small/Rural Lender Advantage to additional regions of the country with the goal of having it rolled-out nationwide by the end of the fiscal year.

4. **Over the last two years, 368 lenders have left the SBA lending programs. How does that loss of lenders impact the Agency's ability to provide capital financing to small firms?**

Answer

The decline in lenders is due to: (1) lenders leaving the SBA loan program; and (2) consolidation of lenders through mergers and acquisitions. SBA is, of course, concerned about lenders leaving the program. These tend to be small lenders that do not generate large numbers of loans and find it challenging to remain current on SBA program requirements. SBA's Small/Rural Lender Advantage is targeted at these lenders by simplifying and streamlining the Agency's application process and procedures for smaller sized SBA loans. Additionally, the updated, simpler loan processing SOP makes it easier to understand program requirements for making SBA loans. The re-engineering in our centralized loan processing, servicing, liquidation and purchase centers also makes it easier to do business with SBA. These improvements are designed to make it more attractive for lenders to offer SBA loan products. Availability of credit is related to demand and SBA has sufficient authorized levels for its loan programs to meet demand.

5. **What type of lender outreach is the SBA doing to bring additional lenders into the program and increase the number of small businesses able to obtain capital through the lenders?**

Answer:

As part of our overall marketing strategy, SBA is reaching out to potential lenders to talk about how our products might help small businesses in their communities. SBA is continuing to introduce a new 7(a) loan initiative designed to meet the unique loan processing needs of small community/rural-based lenders, many of which do not make SBA loans or make very few SBA loans. Small/Rural Lender Advantage is designed to encourage small community/rural lenders to partner with SBA by simplifying and streamlining the Agency's application process and procedures, particularly for smaller SBA loans. SBA introduced Small/Rural Lender Advantage on January 8, 2008, in its Region VIII and is now moving to extend Small/Rural Lender Advantage to additional regions of the country with the goal of having it rolled-out nationwide by the end of the fiscal year. Our district offices are working to identify and reach out to new and low-volume lenders to discuss this product.

6. **What internal actions does the SBA intend to take to contain lending program fees? Would one of the internal actions include suspending SBA lender oversight fees?**

Answer:
SBA believes that suspending lender oversight fees would reduce oversight resources available to the agency, and force SBA to reduce its level of lender oversight. SBA agrees with other federal financial regulators, most of which are currently increasing oversight resources, that we should not be reducing lender oversight activity. Therefore, SBA is focusing its efforts on making its programs more efficient and less costly to its lenders, and the agency is working hard to do so.

However, SBA also recognizes that the fee associated with on-site reviews may have a disproportionately greater impact upon small lenders, and we are looking at ways to minimize the impact of that fee for smaller lenders.

7. **Members of Congress have suggested various changes to improve the SBA's loan programs, including a full, or partial, subsidization of those programs. What are the benefits and drawbacks of having annual appropriations for the 7(a) and 504 loan programs.**

Answer:
Beginning under the Clinton Administration and continuing in the Bush Administration, the SBA has moved to a zero-subsidy loan structure in the belief that this structure is the best way to meet the changing credit needs of small businesses during dynamic market and budgetary conditions.

There are many benefits to using a zero subsidy approach for the 7(a) and 504 loan programs. As the fees are expected to offset the expected default risk, no appropriations for credit subsidies are required for new loan guarantees. Given the very tight budget environment, zero-subsidy allows SBA to ensure capital is available to those small businesses that would otherwise not be credit eligible by providing billions of dollars in authorized levels of loan guarantees. Zero-subsidy provides SBA the ability to provide consistent program availability without the need for subsidy appropriations, providing certainty to borrowers and the lending community. SBA has no evidence to suggest a drop off in any particular type of borrower since zero subsidy was implemented.

The President has not requested budget authority for any of the SBA guaranteed loan programs because a zero subsidy approach to financing the lending programs is the most efficient means of providing consistent access to capital for the small business community. The 504 program has not required credit subsidy appropriations for over 10 years. During this time, the program has grown steadily. By minimizing program cost for the 7(a) and 504 programs, SBA has been able to meet the needs of small businesses without the necessity of taxpayer subsidies or temporary suspensions of loans. An important ingredient to a successful loan program is dependability and the best way to ensure that 7(a) and 504 loan programs can provide a dependable source of financing to the small business community is through the zero subsidy approach.

Finally, the current fee rates result in very modest fee amounts to the borrowers. While FY 2008 year-to-date 7(a) lending is currently down, since moving to zero-subsidy in 2005, SBA has experienced substantial increases in 7(a) lending, evidence that the fee rates (which equal historical levels) have not adversely affected 7(a) demand.

8. **For fiscal year 2009, it would take $100 million, on top of the $101 million of additional funding the Senate's version of the budget resolution allocated to the SBA, to significantly reduce 7(a) fees. What would happen if Senate Appropriators only provided $75 million to reduce 7(a) fees? Could the SBA simply switch back to the zero subsidy model after using up the $75 million during the year? Why or why not?**

Answer

Reducing fees for 2009 would require legislation as our submission for 7(a) was with a subsidy rate of zero as required by law. 15 U.S.C. 636(a)(23). Absent legislation, the $75 million would simply remain available until it expires. Zero-subsidy provides SBA the ability to provide consistent program availability without the need for subsidy appropriations, providing certainty to borrowers and the lending community.

9. **What should be done about increasing fees on SBA lenders? Does the SBA support subsidizing the 7(a) loan program, or repealing lender oversight fees? If the SBA does not support either of these options, what does the SBA propose to do to address the issue of increasing fees during this economic slowdown?**

Answer:

SBA believes that the program as currently structured provides the agency with predictable budgetary resources to manage the 7(a) program. In addition, in conversations with the lending community, it has been apparent that other factors, including declining premiums received for loans sold to secondary market investors, reduced loan demand and an increase in loan (or portfolio) delinquencies are far more critical determinants of lenders' decisions regarding their SBA lending efforts than the fee structure.

However, SBA recognizes that it needs to make its programs more efficient and less costly to its lenders, and the agency is working hard to do so. For example, SBA has invested heavily in process improvements in the National Guaranty Purchase Center to speed up the purchase process and reduce the turnaround time for purchase payments. The agency has increased lenders' ability to update their files online, instead of a time-consuming manual process. SBA has also released a streamlined set of operating procedures for SBA SOP 50 10, to improve lenders' understanding of SBA processes. And we have reduced the time and cost of processing 7(a) loans by giving lenders delegated lending authority through the Preferred Lender and Express programs.

10. How will increasing 7(a) fees and charging lender oversight fees impact the numbers of lenders participating in the program?

Answer:
SBA believes that the overall effect of the lender oversight fee will not be enough to affect lenders' decision to participate in the 7(a) program. Most small lenders are paying nominal amounts, and larger program lenders present enough risk to make the fees reasonable and appropriate and derive enough benefit to make them supportable.

Although the FY2008 off-site review fee has not yet been determined, the off-site review fee billed in 2007 was at a rate of $73 for every $1 million in SBA guarantee dollars outstanding, or less than 1 basis point. Since the fee is based solely on the SBA-guaranteed portion of the loans, the effect of the off-site fee is further minimized. For example, if a lender's portfolio consists entirely of SBA*Express* loans, the lender's off-site fee would apply to only 50% of the total loan amount. In addition, thousands of small lenders will pay no fee whatsoever; the fee will be paid by those lenders that derive the greatest benefit from the 7(a) program through the increased liquidity and government guarantee provided by SBA. In conversations with the lending community, it has been apparent that other factors, including premiums received for loans sold to secondary market investors, the effect of reduced loan demand and an increase in loan (or portfolio) delinquencies, are far more critical determinants of lenders' decisions regarding their SBA lending efforts.

SBA recognizes that the fee associated with on-site reviews may have a disproportionately greater impact upon small lenders subject to on-site reviews. We are looking at ways to minimize the impact of that fee for smaller lenders.

Figure I.

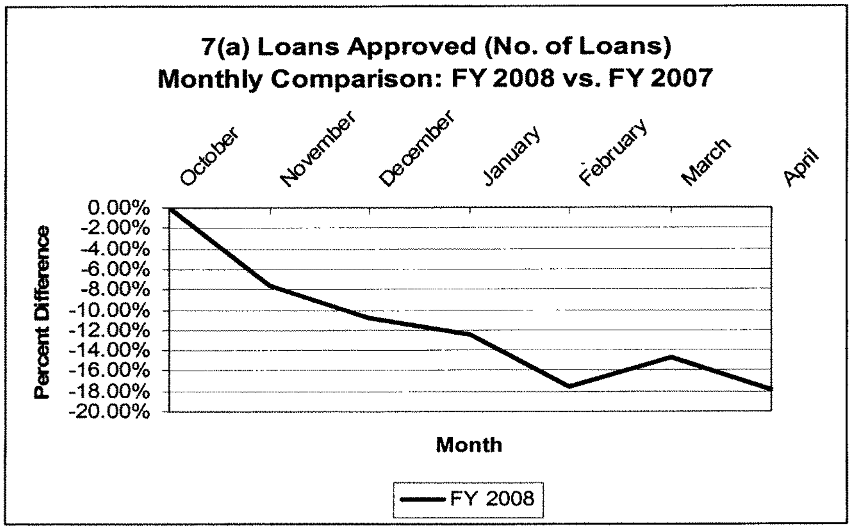
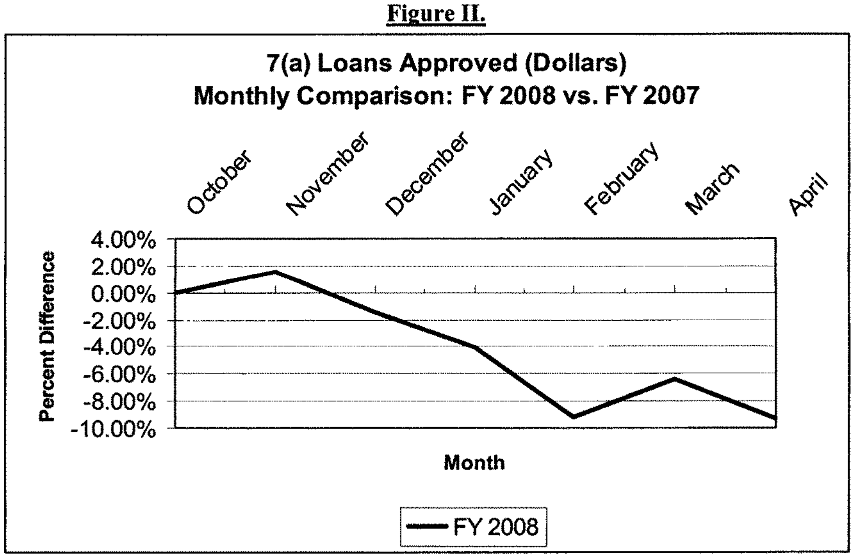
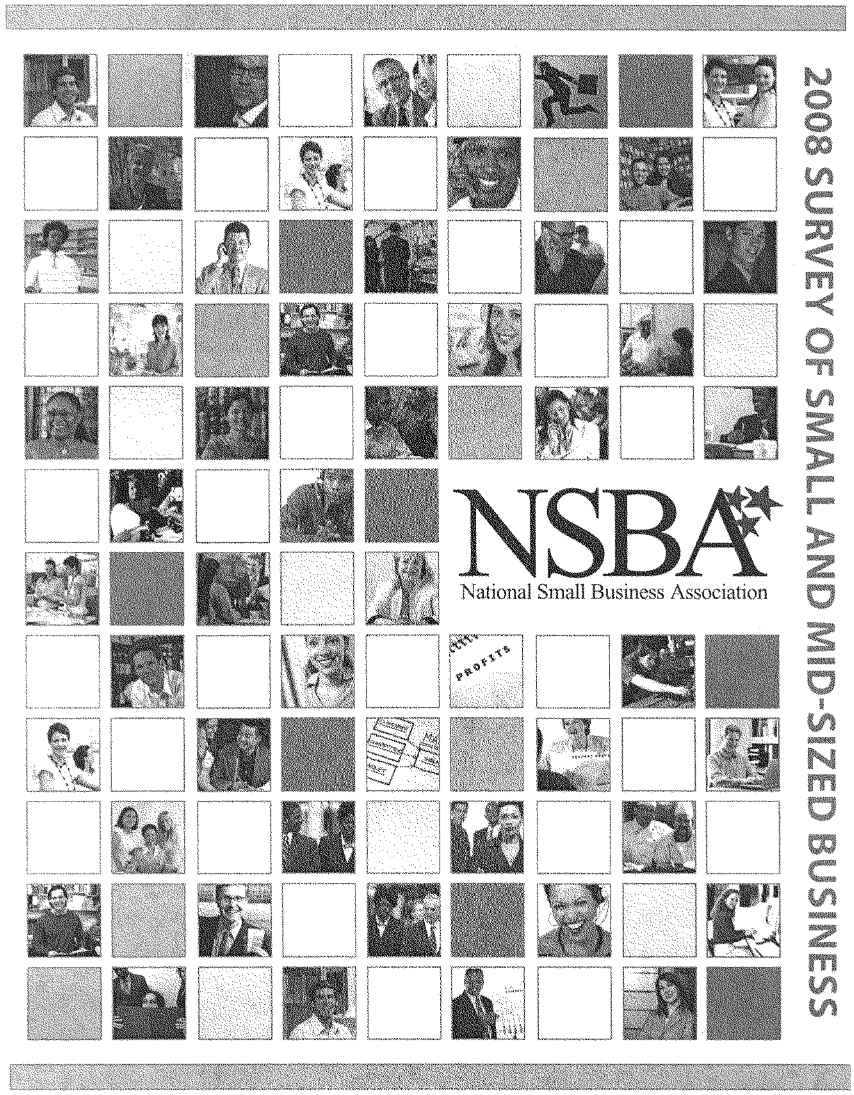


Figure II.



COMMENTS FOR THE RECORD


2008 SURVEY OF SMALL AND MID-SIZED BUSINESS
NSBA
National Small Business Association
PROFITS

FOREWORD

Since 1937, the National Small Business Association has been the nation's leading small-business advocate. As part of NSBA's mission to address the needs and represent the concerns of the small business community, we are pleased to provide you with the findings of the 2008 NSBA Survey of Small Business.

The scope of the survey is large, and the sample of businesses surveyed is diverse and representative of the entire U.S. small business community. Small businesses were asked important questions on economic outlook, employee benefits, access to capital, and presidential politics, to name a few. The results to these questions, along with valuable benchmarking data, are provided in this survey report. Information from this year's study is compared with studies from past NSBA surveys, providing a wealth of useful trend information.

Although the 2008 survey shows that small-business owners have a significantly worse outlook for the overall economy from 2007, there was only a slight dip in the confidence they expressed about their own business outlook. Clearly, the self-reliance, optimism and persistence necessary for entrepreneurial success are alive and well.

As the nation focuses on the 2008 election cycle, small business remains one of the most important yet least talked about voting blocks. Thus, NSBA launched the Small Business: 70 Million Strong...And Voting campaign which seeks to educate lawmakers, candidates and the public on the importance of small business. The results of this survey, along with data collected from the U.S. Census and Small Business Administration Office of Advocacy, will highlight the importance of the small-business community throughout the coming months.

With unemployment on the rise, more and more people will look to entrepreneurship as a meaningful way to make a living. The economic slowdown we find ourselves in makes it absolutely crucial to have government policies that foster entrepreneurial growth. The findings of this survey are presented to members of the media and policy makers so that they can make informed decisions when working on key small business issues vital to our nation's continued growth and development.

We hope you find this survey useful, and welcome your feedback as we plan future surveys and research projects.

Todd McCracken
President

Marilyn Landis
2008 Chair

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EXECUTIVE SUMMARY

America's small businesses are waving the yellow flag. They are extremely anxious about the economy and fear a recession on the horizon. The past year has not been a good one for the small-business economy, and projections for the next twelve months are even less optimistic.

ECONOMIC OUTLOOK

America's small-business owners perceive a dramatic shift in the economic climate and express anxiety over a looming recession. Across a host of economic measures, small-business owners express significant trepidation about what is in store:

- Seven out of ten (71 percent) business owners say the economy is worse today than five years ago. This represents a significant shift from just one year ago, when 43 percent of businesses surveyed said the economy is worse.
- Nearly half of all business owners (45 percent) expect a recession in the next year, while an equal number (45 percent) expect a flat economy. Just 9 percent say they anticipate economic expansion.
- Fifty percent (50 percent) of those surveyed say "economic uncertainty" is one of the most significant challenges they face to the growth and survival of their business.

On a slightly more encouraging note, small-business owners remain confident in their own futures.

- Seventy percent (70 percent) of all business owners say they are confident in the future of their business. However, this does mark a noteworthy drop from last year, when 81 percent of business owners said they were confident in their business' future.
- Confidence is not shared equally, with only 64 percent of companies with four or fewer employees expressing confidence in their future.

Expecting much growth in sales, profits, or jobs created is not likely to happen, at least for now. Companies are asked whether they have experienced in the last year, or expect changes in the next year across these economic indicators:

- Gross Sales Revenue
- Net Profits
- Number of Employees
- Employee Compensation

- Sales and profits are down, and fewer jobs are being created in 2008 than at any period over the last 15 years during which this survey has been conducted.
- Equally as concerning, the outlook of business owners for the next twelve months is less optimistic that at any point since 1993. Fewer companies report expectations for increases in sales or profits, and fewer than one out of four companies expect to bring on more employees.

LABOR AND EMPLOYMENT ISSUES

Economic conditions also take a toll on employee compensation. Small businesses struggle to keep up with the benefits workers want. Health care insurance continues to be the dominant concern.

- Seven out of ten (69 percent) small-business owners say "health/medical insurance" is the most important benefit to prospective employees.
- But, just one in four companies (25 percent) with four or fewer employees is able to offer a health benefit.
- Overall, the significant trend of fewer companies offering health benefits continues. In the 2000 survey, 51 percent of companies surveyed were offering a health benefit. This figure dropped to 41 percent in 2007, and to a low of 38 percent in 2008.
- Bigger small businesses that are more likely to provide a health benefit (71 percent) are aggressively seeking ways to trim costs, including being forced to pass more of the costs on to their employees, or changing policies to ones with higher deductibles and co-pays.

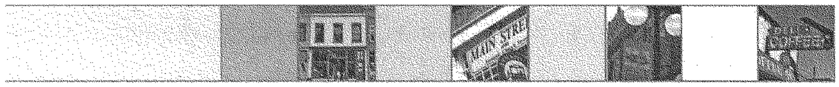
FINANCING

Businesses of all sizes are feeling the impact of the credit crunch. More than half (55 percent) of business owners surveyed said they have faced difficulty securing credit over the last year.

- Despite signs of the economic downturn, 70 percent of companies surveyed say they are able to obtain adequate financing, which is essentially no different from 2007 (67 percent).
- But, America's smallest companies do face bigger hurdles – over one-third (35 percent) of companies with four or fewer employees say they cannot get the financing they need.

Half of American businesses are living on loans.

- Fifty-four percent (54 percent) of small businesses have some type of business loan. To leverage these loans, business owners look to credit cards, personal savings, and their homes as primary sources.
- In a 21st Century trend, credit cards continue to be one of the primary sources of financing for small businesses.



- Forty-four percent (44 percent) of small businesses have used a credit card in the last twelve months to help finance their capital needs. America's smallest companies are most reliant on credit cards.

Certainly, if capital were more widely available, companies would be making new investments.

- Of the 72 percent of companies that said they would make changes to their company if they had additional capital, the top three strategies include: investing in advertising; hiring additional employees; and investing in a new plant or equipment.

PUBLIC POLICY

Facing more economic uncertainty this year, small-business owners want the next President to reduce the tax burden.

- Asked to name the issue most important for the next President to address, 40 percent say it is reducing the tax burden, followed by addressing health care costs (32 percent).

Business owners remain adamantly opposed to an employer mandate in health care.

- While small-business owners want the issue of health care to be addressed, 70 percent reject the idea of an employer mandate. They are more receptive to an individual mandate (66 percent favor).

Energy prices are also placing a heavy toll on American business, and have created a ripple effect in our economy.

- Fully 77 percent of business owners surveyed say rising energy prices have had a negative effect on their business. In response to rising costs, 37 percent of businesses have increased their prices, 33 percent have reduced their business travel, 11 percent have cut their production schedule, and 10 percent have reduced their workforce.
- On a more positive note, 18 percent of these companies have taken steps to invest in more energy efficient equipment or upgrades.

METHODOLOGY

On behalf of the National Small Business Association, Public Opinion Strategies conducted a national Internet survey of 500 small and mid-sized business owners from February 15-25, 2008. To ensure results represented a proper distribution by company size for the small and mid-sized business market, the results were weighted by 2004 U.S. Census Bureau of the Census data.

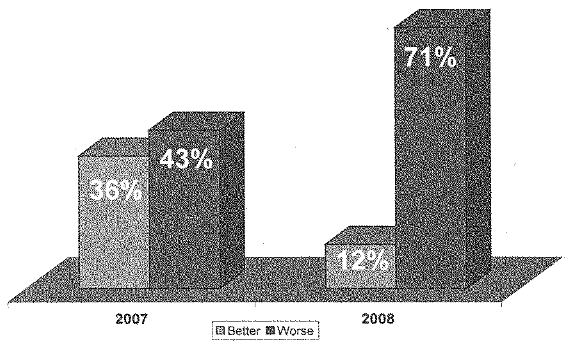
Profile of Respondents

Profile of Respondents	
Number of Personnel	
0	7%
1–4	54%
5–19	28%
20–99	9%
100–499	2%
Number of Years in Business	
Less than 1 year	5%
1–3 years	11%
4–6 yeears	16%
7–10years	18%
11–15 years	13%
More than 16 years	38%
Revenues for Most Recent Fiscal Year	
Less than $100K	35%
$100K–$500K	26%
$500K–$1M	14%
$1M–$5M	16%
$5M–$25M	5%
$25M–$75M	1%
$75M–150M	1%
More than $150M	1%
Location of Business	
Northeast	23%
Midwest	22%
South	31%
West	24%

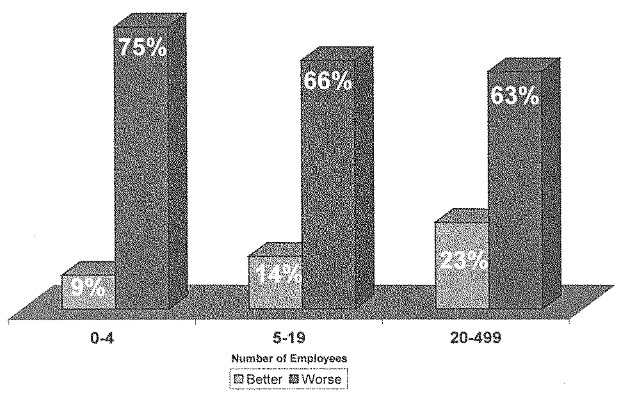
BUSINESS ENVIRONMENT

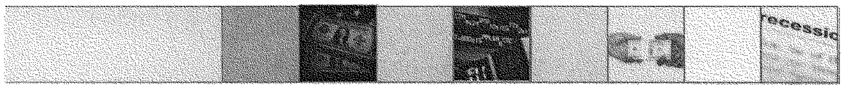
In a little less than a year, perceptions about the national economy have shifted quite dramatically.

"Compared to five years ago, would you say the national economy is..."



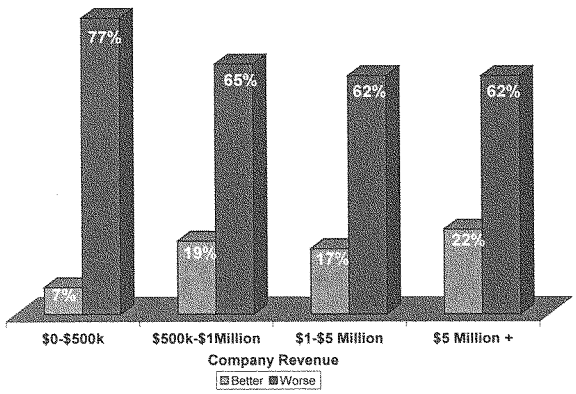
Companies of all sizes recognize a slumping economy, but smaller firms have a more negative outlook.





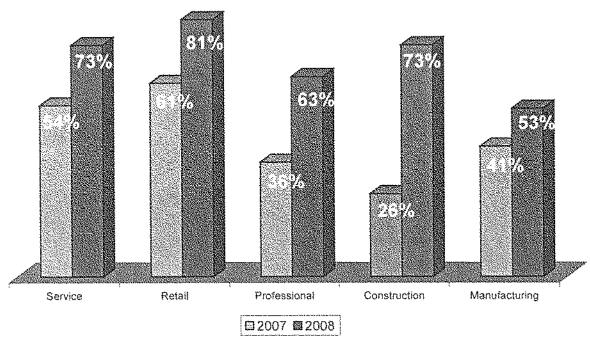
Companies with less revenue also perceive the economy to be worse.

"Compared to five years ago, would you say the national economy is..."



The construction industry's economic outlook is vastly different from last year's, a likely indicator of the housing market crash and slumping economy

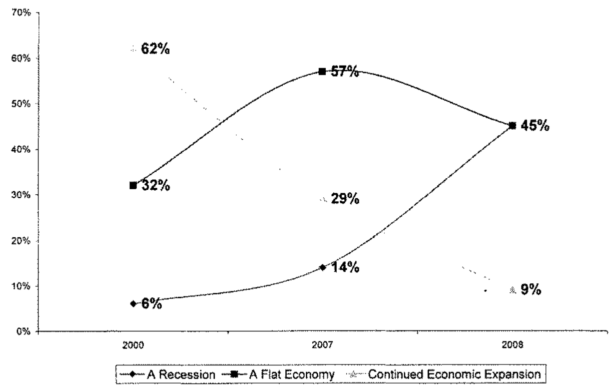
Total Worse



ECONOMIC OUTLOOK

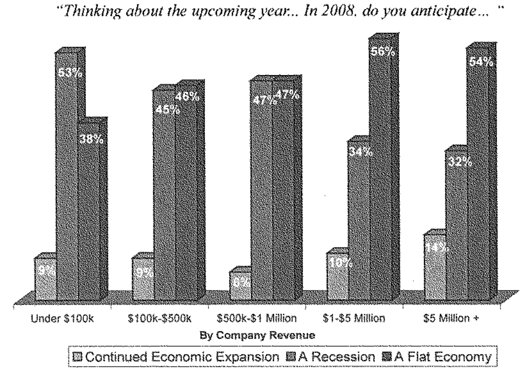
Optimism has plunged since 2000.

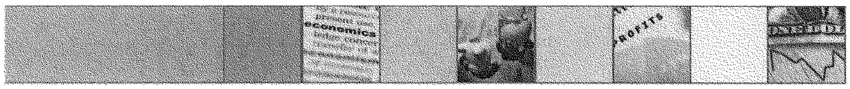
Thinking about the upcoming year... In 2000, 2007 and 2008, do you anticipate... "



The companies with the least revenue express most concern that a recession is on the horizon.

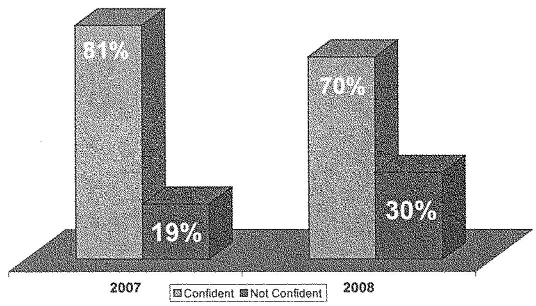
"Thinking about the upcoming year... In 2008, do you anticipate... "





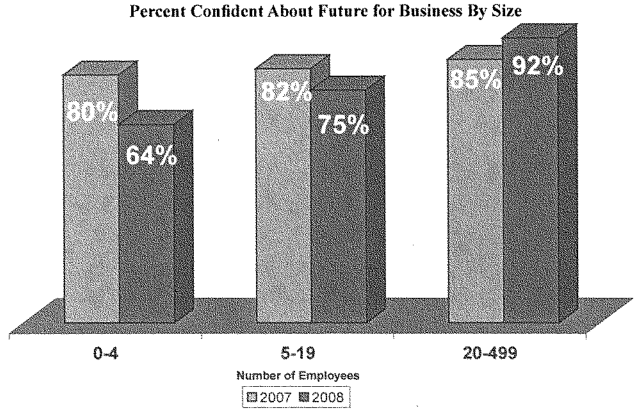
Although seven out of ten small-business owners remain confident about their business future, one-third expressed concern about their survival.

"From a financial perspective, how do you feel right now about the future for your business? "



Confidence is lowest among the smallest companies...

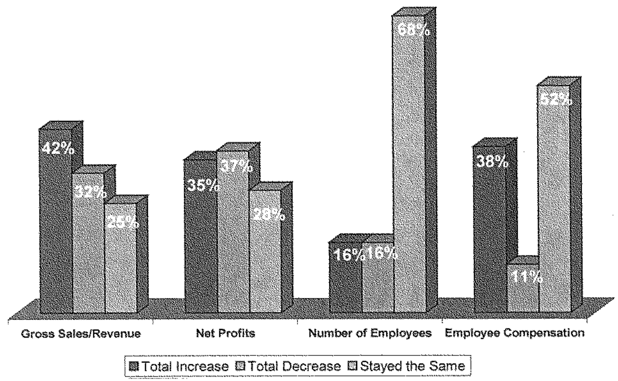
Percent Confident About Future for Business By Size



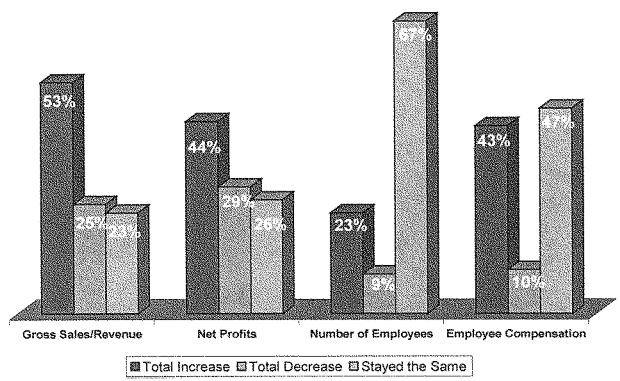
ECONOMIC OUTLOOK

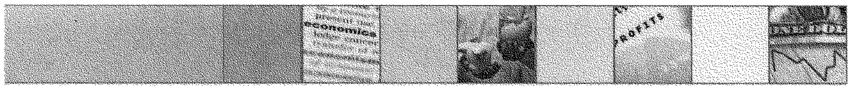
Business growth in the past 12 months and projected growth for the coming year is down significantly.

"In your business, how have the following four areas changed over the LAST 12 MONTHS?"



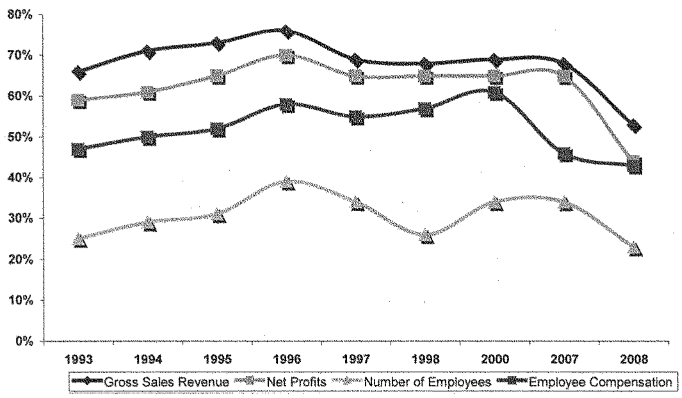
"In your business, how much do you expect the following four areas to change over the NEXT 12 MONTHS?"



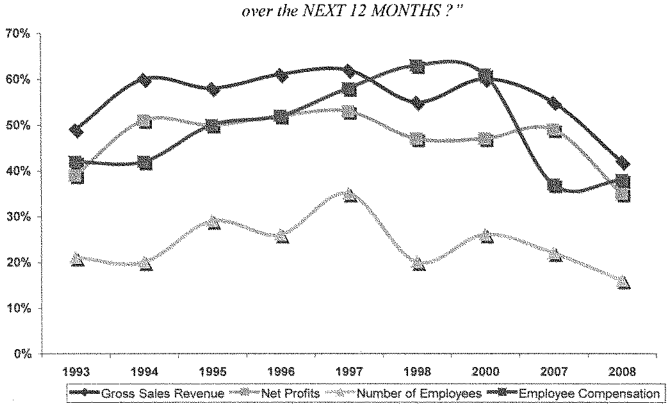


The 2008 growth numbers are the lowest measured since this survey began in 1993.

"In your business, how have the following four areas changed over the LAST 12 MONTHS ?"



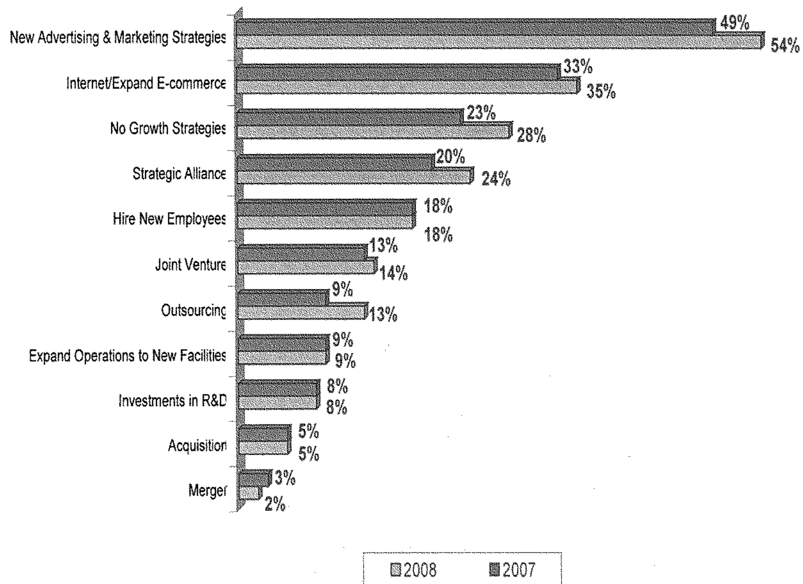
"In your business, how much do you expect the following four areas to change over the NEXT 12 MONTHS ?"

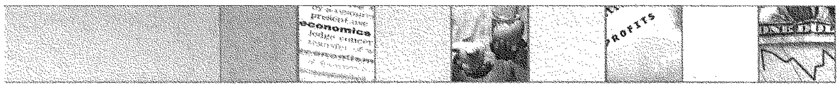


ECONOMIC OUTLOOK

Companies are looking at more constricted growth strategies compared to a year ago.

"Which of the following growth strategies will you use in the next 12 months?"





ENTREPRENEURS

"While the 2008 NSBA Small Business Survey finds that small businesses have a very negative outlook about the economy as a whole, they remain somewhat optimistic about their own prospects. This tracks closely with what we'd expect to see from self-starting entrepreneurs."

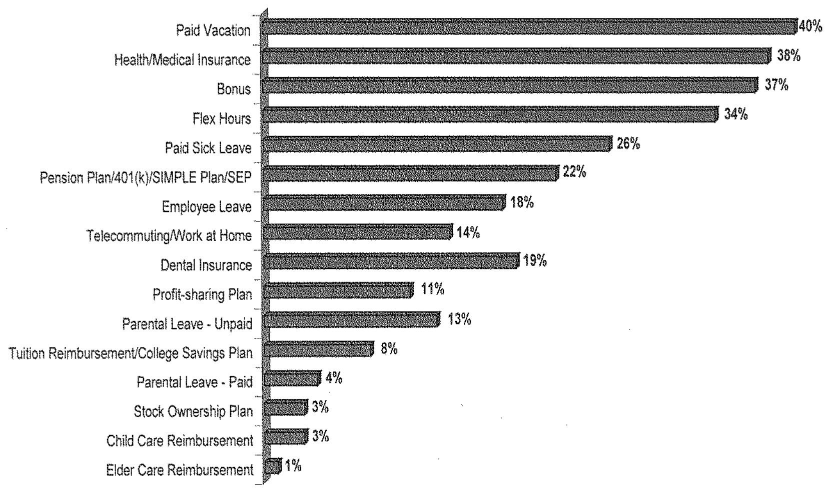
-Glen Bolger, partner and co-founder of Public Opinion Strategies

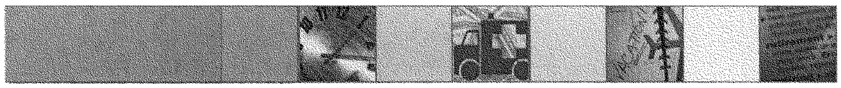
SURVEY

EMPLOYEE & LABOR ISSUES

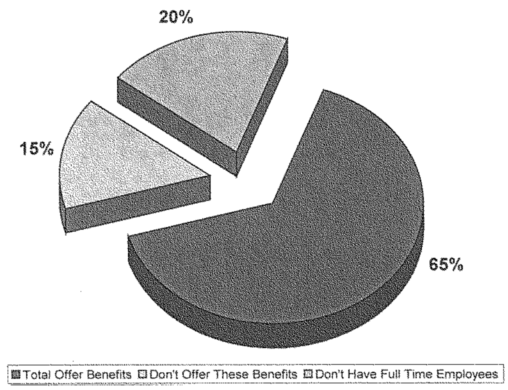
Although the number of employers offering some type of employee benefit is down slightly from last year, a majority continue to provide employee benefits.

"Thinking now about employee benefits, which of the following do you offer to your full-time employees?"





More than six out of ten companies offer some type of employee benefit.



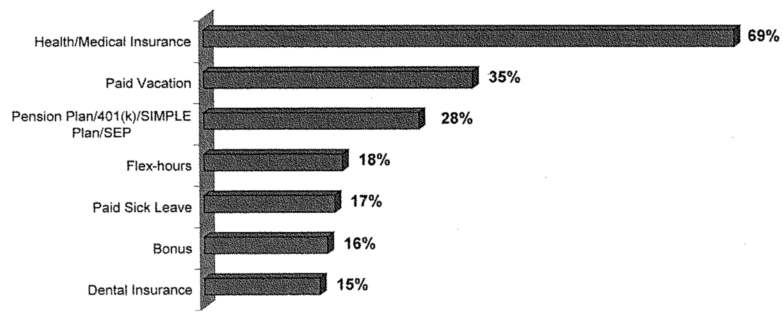
The drop-off since 1993 in companies offering health benefits is significant.

Employee Benefits	1993	1994	1995	1995	1997	2000	2007	2008	Change from 2007-2008
Health/Medical Insurance	61%	63%	67%	63%	58%	51%	41%	*38%*	-3%
Bonus	43%	47%	49%	53%	55%	*	39%	*37%*	-2%
Flex-hours	34%	34%	32%	35%	36%	41%	35%	*34%*	-1%
Paid Sick Leave	44%	48%	52%	45%	45%	*	28%	*26%*	-2%
Pension Plan/401(k)	21%	29%	28%	29%	28%	28%	22%	*22%*	0%
Employee Leave	18%	21%	22%	15%	19%	27%	19%	*18%*	-1%
Work at Home	*	*	*	9%	12%	16%	19%	*14%*	-5%
Dental Insurance	22%	25%	25%	26%	*	*	17%	*19%*	2%
Profit-Sharing Plan	16%	20%	20%	23%	19%	15%	12%	*11%*	-1%
Parental Leave - Unpaid	17%	20%	18%	17%	16%	16%	12%	*13%*	1%
Tuition Reimbursement	15%	17%	19%	19%	14%	*	8%	*8%*	0%
Parental Leave - Paid	5%	5%	7%	6%	*	*	4%	*4%*	0%
Stockownership Plan	4%	6%	6%	4%	3%	3%	3%	*3%*	0%
Childcare Reimbursement	2%	3%	2.5%	1.8%	3%	3%	1%	*3%*	2%
Elder Care Reimbursement	*	1%	0.5%	0.1%	0.3%	1%	1%	*1%*	0%

EMPLOYEE & LABOR ISSUES

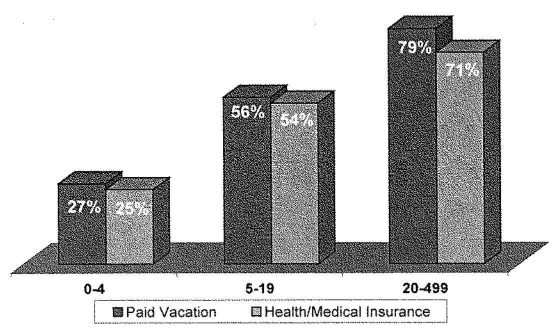
As has been the case in past surveys, health insurance is the benefit employers most want to provide their employees.

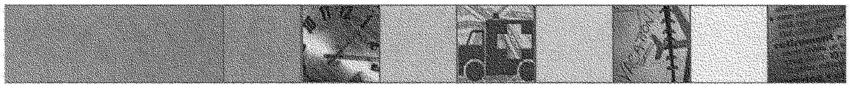
"What would you say are the two or three most important benefits, regardless of whether your company is currently able to provide the benefit, to prospective employees at your company?"



Smaller companies are struggling to keep up with the benefits workers want.

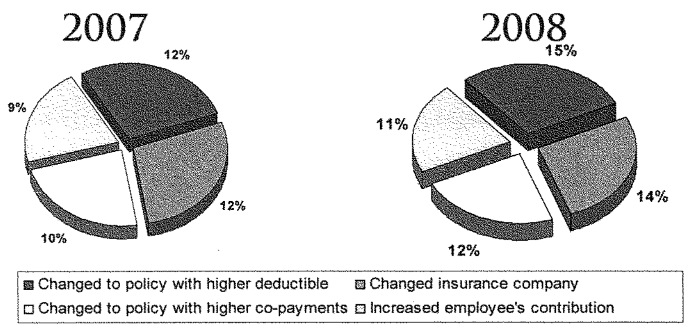
"Which of the following do you offer to your full-time employees?"





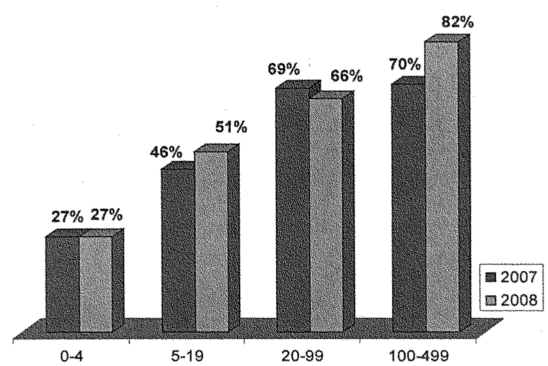
Companies are being forced to pass their costs on to their employees.

"In order to better manage health care costs, has your company done any of the following within the LAST 12 MONTHS?"



The bigger companies are the ones more aggressively seeking ways to trim costs, and are the ones most likely to be offer health benefits.

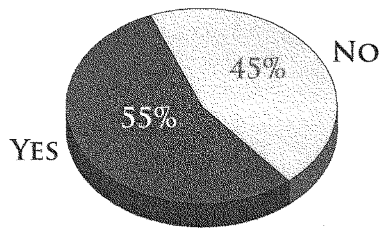
Percent Cutting Health Care Costs by Company Size



FINANCING

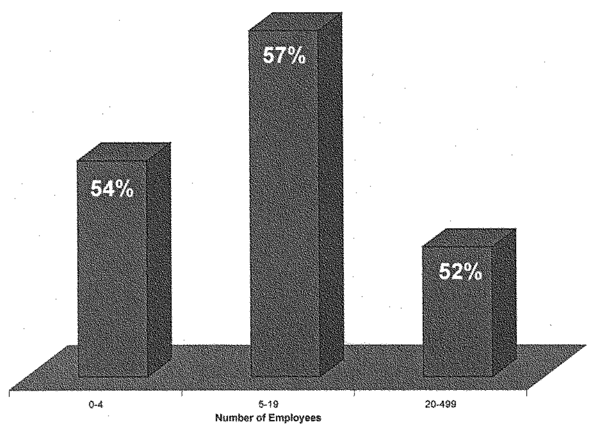
More than half of businesses surveyed have felt the impact of the credit crunch.

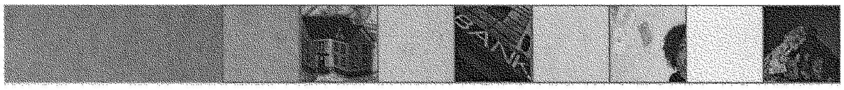
"In the last six months, has your business had difficulty securing credit?"



The impact of the credit crunch is being felt across companies of all sizes.

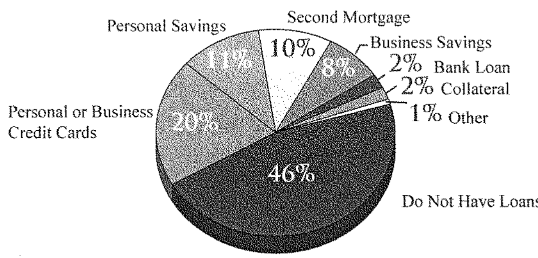
Difficulty Securing Credit- Percent Yes



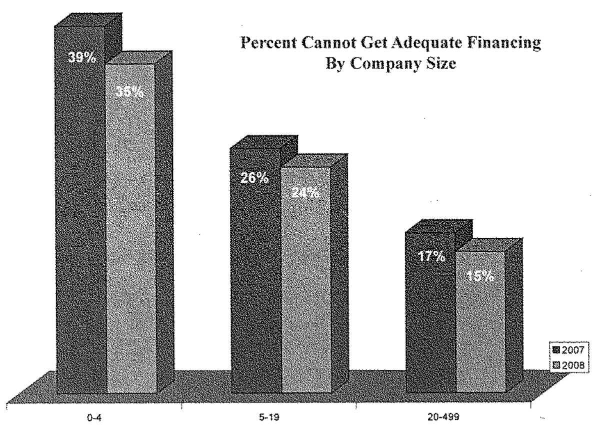


More than half (54 percent) of the companies surveyed have some type of business loan. Those companies with loans look to credit cards, savings and their homes as primary sources to leverage their loans.

"How do you leverage your business loans?"



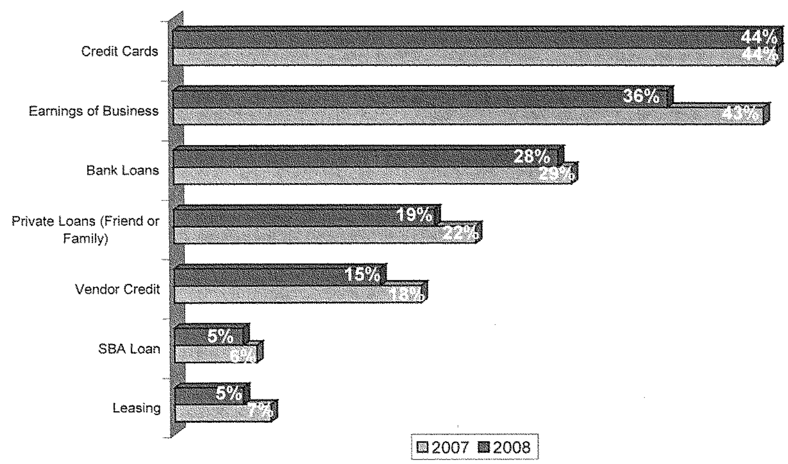
Financing continues to be more of a challenge for America's smallest businesses.



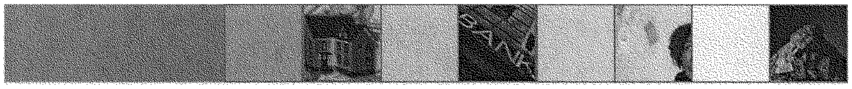
FINANCING

Businesses use a multitude of financing options to meet their capital needs, with credit cards topping the list.

"What types of financing has your company used within the LAST 12 MONTHS to meet your capital needs?"

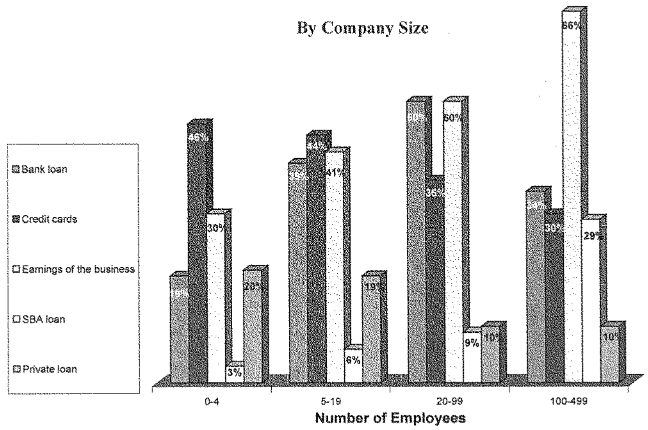


Credit cards are the only source of financing that did not decrease between 2007 and 2008.

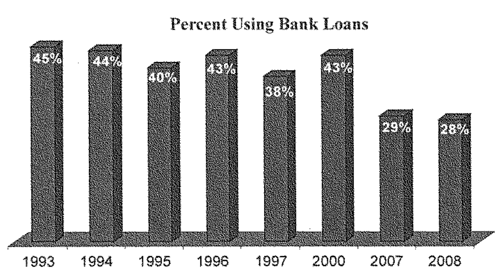


Bigger businesses can rely on bank loans and their earnings, while smaller companies come to depend more on credit cards and private loans.

"What types of financing has your company used within the LAST 12 MONTHS to meet your capital needs?"



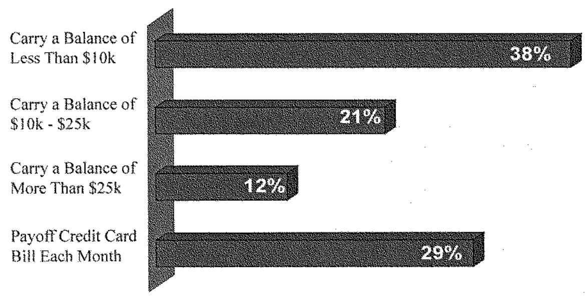
Small businesses using bank loans for financing has reached an all time low.



FINANCING

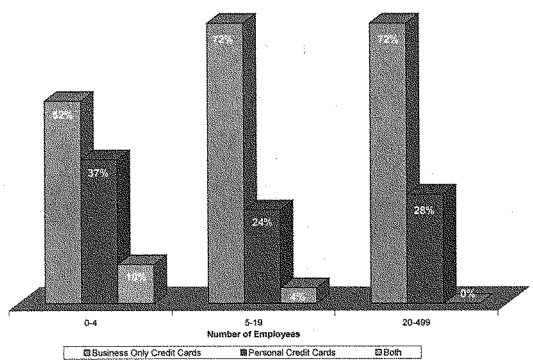
For companies using credit cards, they are carrying sizable balances.

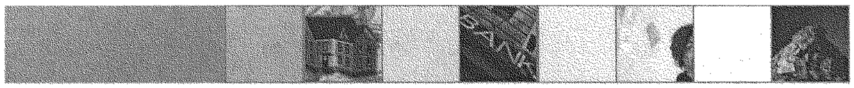
"Thinking about your business' credit cards... Do you carry a balance of less than $10,000, carry a balance of $10,000-$25,000, carry a balance of more than $25,000, or pay off your credit card bill each month?"



Companies with less revenue are forced to rely more on personal credit cards

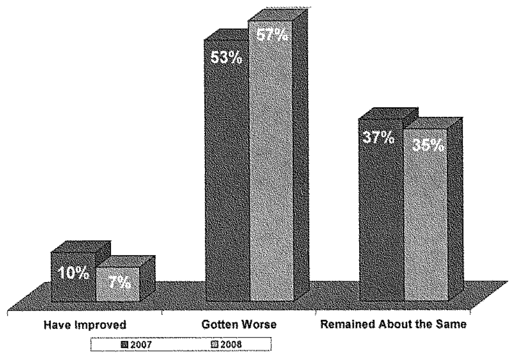
"What kinds of credit cards do you use?"



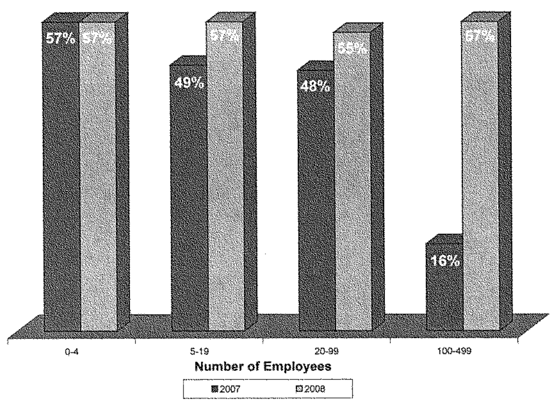


Although interest rates decreased slightly for business credit cards, the small-business owners believe their credit card terms are getting worse.

"Do you believe that the terms on your business credit cards, including interest rates, late fees, time to pay in full, etc., have improved, gotten worse, or remained about the same over the last five years?"



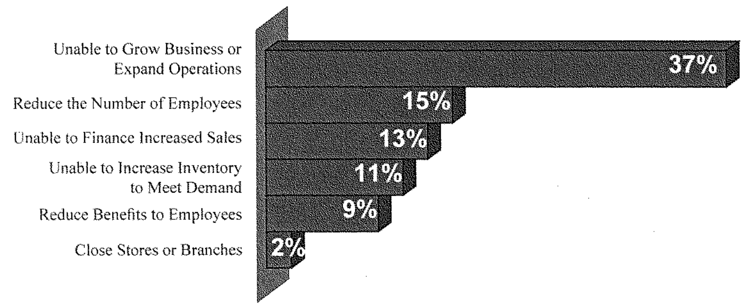
Medium-sized businesses report the greatest jump in worsening credit card terms.



FINANCING

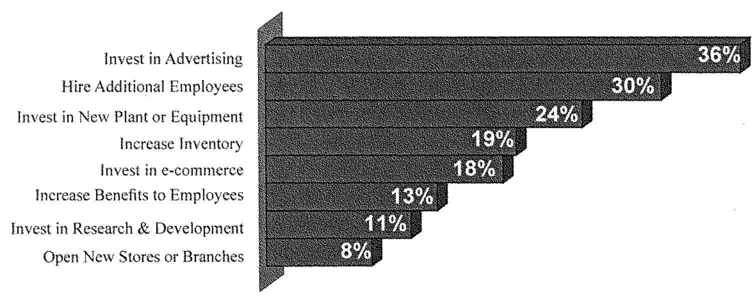
Simply put, the lack of capital means these businesses just don't grow.

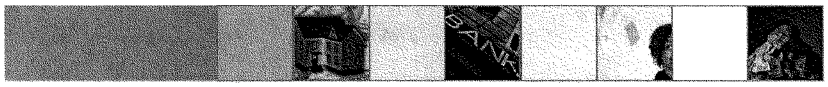
"If capital availability is a problem for your business, what is the effect on your operations?"



Businesses impaired by an inability to access financing would grow their business if additional capital was available

"If you were able to obtain additional capital for your business, what are the first three actions that you would take?"





SMALL BUSINESS

ECONOMIC

"Our survey shows plain and clear how the economic slowdown is affecting small business. When asked last year about their economic outlook, a majority of small -business owners responded positively. This year, a whopping 71 percent have a negative outlook on the economy—clearly small business is feeling the pinch."

- NSBA President Todd McCracken

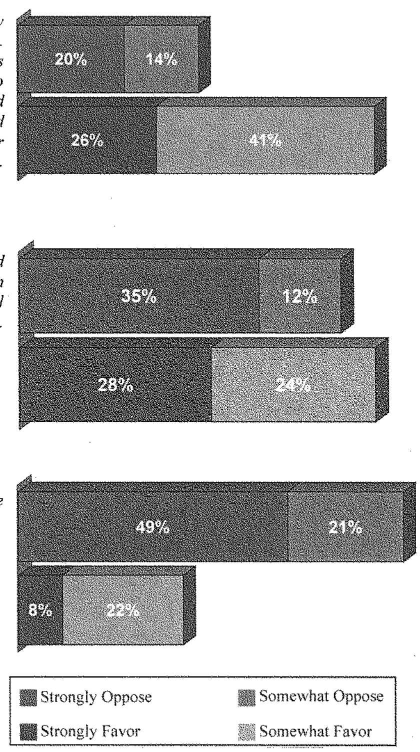
SLOWDOWN

PUBLIC POLICY

Small businesses support health care reform that would ensure every individual has health coverage, but reject a government mandate on businesses to provide it.

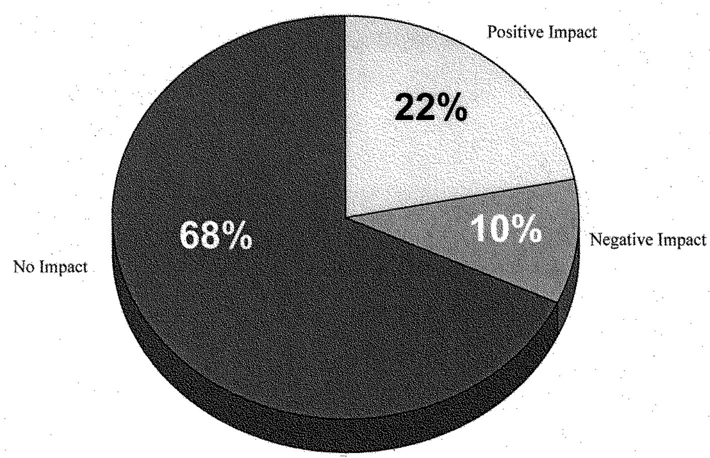
Respondents were asked to rate their support of the following health care reform proposals:

- *Require that every individual in this country secure a basic health care coverage package. To assist with this, insurance companies would be required to offer coverage to people with pre-existing conditions, and individuals and families would be provided with federal financial assistance to pay for health care premiums based on income.*
- *A federally-funded, government–administered health care system financed through taxes in which everyone has health care coverage for all medically necessary treatment and procedures.*
- *A requirement that all employers must provide health insurance benefits to all employees.*



The positive outcomes to estate tax reform far outweigh negatives for small business.

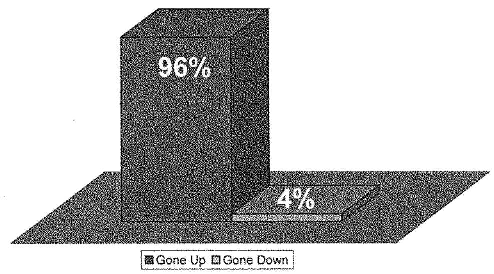
"If estate tax reform included an exemption on estates up to $7.5 million, how would your business be impacted?"



PUBLIC POLICY

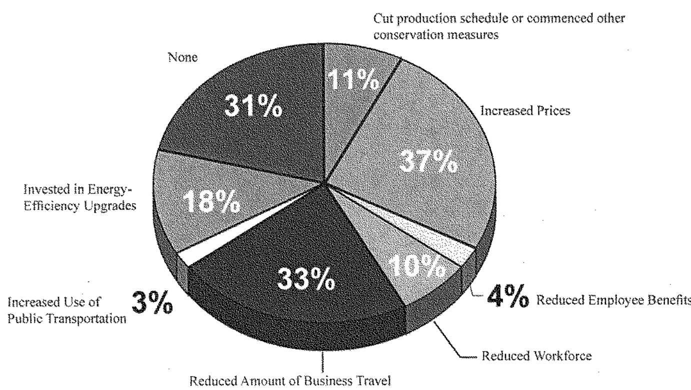
The overwhelming majority of small businesses have faced higher energy costs.

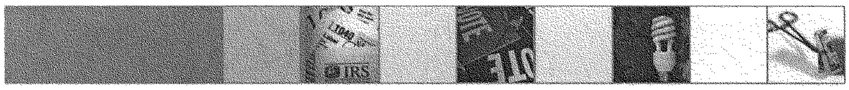
"In the last 12 months, have the prices you pay for the energy consumed at your business gone up or gone down?"



Businesses have been forced to take steps to mitigate the impact of higher energy prices.

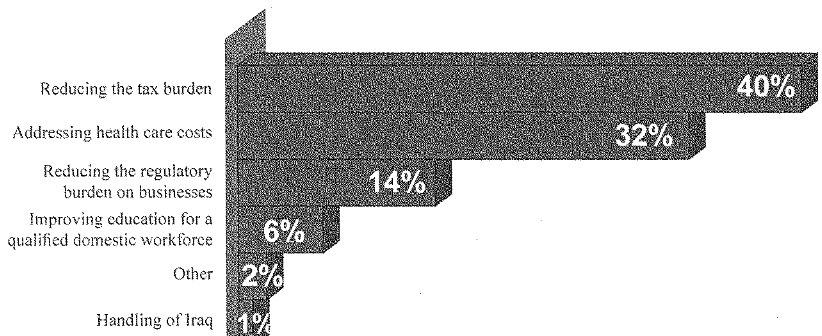
"In response to rising energy costs, which of the following steps have you taken?"





When considering who to vote for in the upcoming election, taxes and health care are the most important issues to small businesses.

"Which one of the following issues would be most important to your business as you consider who you might vote for in the next election for President?"



Independent (20%)	
Reducing the Tax Burden	(36%)
Addressing Healthcare Costs	(34%)
Reducing the Regulatory Burden of Business	(12%)

Democrat (33%)	
Reducing the Tax Burden	(49%)
Addressing Healthcare Costs	(24%)
Reducing the Regulatory Burden of Business	(11%)

Republican (48%)	
Reducing the Tax Burden	(54%)
Addressing Healthcare Costs	(19%)
Reducing the Regulatory Burden of Business	(16%)

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