TESTIMONY OF

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On
"Improving Responsible Lending to Small Businesses"

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FINANCIAL SERVICES SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
UNITED STATES HOUSE OF REPRESENTATIVES

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Lawrence Technological University, Southfield, Michigan

Good afternoon Mr. Chairman and distinguished Members of Congress. My name is Ned Staebler and I am the Vice President for Capital Access and Business Acceleration at the Michigan Economic Development Corporation. I sincerely appreciate the opportunity to testify today on this very important subject.

Today, manufacturers in the United States face considerable uncertainty after a protracted recession that threatened to bring down the entire economy. While some firms are cautiously optimistic about the overall economic recovery, the persistent lag in credit markets continues to pose a serious and permanent threat to manufacturers and to our country's industrial capacity.

The timing for this credit lag couldn't be worse. Our manufacturing capacity is the key ingredient for a successful transition to the new, green economy that will propel America's future growth. But we are falling behind. As we speak, China, Germany, and other nations are seizing the opportunity by heavily investing in their industrial capacities, and will take the lead in the new economy unless we act soon.

The situation is exacerbated by conflicting reports on the state of the market. On one hand, in recent months, the Institute for Supply Management reported an increase in the ISM Manufacturing Index, indicating an uptick in economic activity[1]. The Federal Reserve, on the other hand, recently reported what was described in the Wall Street Journal as "a sharp slowdown in U.S. manufacturing activity" during the month of October that "raised concerns that the economy's nascent recovery is losing steam"[2]. What is clear from a deeper reading of

[1] "Manufacturing ISM Report". Institute for Supply Management. October, 2009.
[2] Kelly Evans. "Manufacturing Slows, Clouding Recovery". Wall Street Journal. November 18, 2009.

both reports is that while conditions are somewhat improved from the lows seen in the first quarter of 2009, U.S. manufacturing output is still very weak compared to historical levels and utilized capacity remains at, or near, all time lows.[3]

In Michigan, and from our view at the Michigan Economic Development Corporation (MEDC), the state of the market is clear. Unemployment in the state is at 15.1%[4]. A recent University of Michigan report projected the state will have lost nearly 1 million jobs by the time we reach bottom, over half of those losses coming from the manufacturing sector[5]. And A.T. Kearney estimates that 50 percent of tier one automotive suppliers are at risk of bankruptcy[6]. Perhaps most troubling is that the automotive industry has one of the largest economic multipliers of any sector in the U.S. economy[7], a reminder that other non-auto jobs are tightly linked to the success or failure of the auto industry. Finally, we know by the steady demand from banks and borrowers for our new manufacturing loan enhancement programs at MEDC, that action is necessary to induce new loans more quickly.

Even with the interventions of TARP, designed to improve the health of the banking sector and increase available capital to businesses, commercial and industrial lending across the U.S. has fallen 8% over the last twelve months[8]. In Michigan, the decline is over 10.5%[9]. Clearly, the recovery plan has not done enough to increase the flow of credit from private lenders.

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[3] Federal Reserve Statistical Release, Industrial Production and Capacity Utilization, November 17, 2009
[4] "Labor Market Information". Michigan Department of Labor, Energy, and Economic Growth. October, 2009.
[5] George A. Fulton. "RSQE Forecasts". University of Michigan Seminar in Quantitative Economics. November 20, 2009.
[6] Doug Harvey. "Happier Times Ahead for Auto Suppliers?" A.T. Kearney. April, 2009.
[7] David Cole. "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers". Center for Automotive Research. November 4, 2008.
[8] "Quarterly Banking Profile". Federal Deposit Insurance Corporation. Second Quarter.
[9] Michigan Bankers Association.

This scarcity of credit is particularly impactful on the manufacturing sector which is very capital intensive and often requires the financing of inventories and receivables over long periods of time. Additionally, today's depressed asset values have been especially detrimental to manufacturers that have historically used property, plant, and equipment and receivables as collateral to finance operations.

This juncture is critical for three reasons: (1) manufacturers need capital to reorganize and consolidate efficiently and in an orderly fashion to improve their financial health; (2) those manufacturers who have 'right-sized' and are now seeking to fill new orders are finding that with their reduced borrowing bases, it is difficult to access capital to scale back up; and (3) those manufacturers seeking to utilize their core competencies in advanced manufacturing in non-traditional verticals (wind, solar, medical device, homeland defense) are increasingly unable to finance this transition.

We applaud many of the efforts of Congress and the Obama Administration to address these issues. Increasing access to, cost of, and timing for capital to manufacturers will be an essential part of our nation's economic recovery. Increasing SBA guarantee levels, reducing fees, and reducing administrative hurdles should continue to be Administration goals and we urge this Committee to support them.

However, we feel that these measures overlook the deep interdependence between the health of banks and the health of borrowers. TARP and many of the SBA adjustments described above focus on the health of banks but fail to fully address the problem. We agree that banks need to be healthier, and access to cheaper capital helps. But to grow our deflated manufacturing sector, borrowers must be made healthier as well. Lowering the cost of capital to banks, increasing guarantees, and reducing fees and bureaucracy do not change the fundamental business of banks: making loans to borrowers with reliable cash flows and sufficient collateral values on a margin. Nor should they. We are not suggesting that underwriting standards be lowered at all.

Rather, the best way to widen the scope of lenders to include manufacturers and other historically healthy firms, in this environment, is to enhance borrowers' financial qualifications from a commercial loan underwriter's perspective. This requires mechanisms targeted specifically at borrowers' shortcomings: cash flow and collateral.

In recognition of this fact, the MEDC created the Michigan Supplier Diversification Fund (MSDF), which has been very successful in inducing new loans that were otherwise unqualified from the bank's perspective, many of which provided funds for diversification into emerging, green industries.

The Fund does this via two mechanisms designed to address the financial health of the borrower. One mechanism supports the cash flow of borrowers by purchasing a portion of a loan and offering a grace period on that portion. Another mechanism supports depressed collateral values by depositing cash collateral into the lending institution.

MSDF also supports the health of participating banks in two ways. The cash flow support mechanism supports the bank by offsetting its default risk exposure and supporting its debt service coverage. The collateral support mechanism actually deposits cash collateral into lending institutions which increases collateral coverage and core deposit base which helps the bank's capitalization ratio.

Also crucial is that the program targets its support of banks and borrowers at the individual loan request level. This ensures that projects move forward at the time of the deployment of funds. The program only expends capital when a development project (and its associated job creation) occurs. In essence, the program self regulates by ensuring that the lending activity happens right away, in contrast to TARP, where follow on lending has severely lagged.

MSDF leverages the market expertise, prudent risk management practices, and financial capacity of private lenders, who source, underwrite, lead, and service the deals, while injecting targeted public dollars at the level of individual loan requests. So far, every $1 in public funds has leveraged $3 in private funds.

MSDF has been well received by the lending and manufacturing communities in Michigan. In less than three months since inception, over 85 percent of the limited ($13.2 million) fund has been committed and the pipeline of deal flow far exceeds the initial fund capitalization. It is critical that more funds be deployed. There is an estimated need of at least $1 billion in Michigan, and approximately $8-10 billion nationally[10].

[10] Robert E. McKenna. "Emergency Financial Assistance Request". Motor & Equipment Manufacturers Association. June, 2009.

Should we fail to address this gap, a chain reaction of bankruptcies is a real possibility, particularly in a protracted period of slow growth and high unemployment. Auctions would be held at the doorsteps of failed manufacturers. And the beneficiaries will be China and India, who will use our best equipment, which they will have purchased at cents on the dollar.

As evidenced by the 15+ percent unemployment rate in Michigan, the transition of the American manufacturing base from traditional sectors to new high tech verticals is a challenging one. However, the speed of this transition is crucial to the retention of an advanced manufacturing cluster in the United States.