

Testimony of Paul Atkins  
Member, Congressional Oversight Panel  
before the  
House Financial Services Committee  
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Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee, I am Paul Atkins, a member of the Congressional Oversight Panel. I appreciate this opportunity to testify about the Panel's work assessing initiatives to promote small business lending, jobs, and economic growth. I should note that the views expressed in this testimony are my own. I will do my best to convey the Panel's views, but my statements cannot always reflect the opinions of our five diverse thinkers.

The Secretary of the Treasury recently designated small business credit access as a primary focus of the Troubled Asset Relief Program (TARP), and he pledged TARP funds "for additional efforts to facilitate small business lending." Because the Panel is mandated to review the Secretary's use of his TARP authority, oversight in this area is an important statutory role of the Panel.

Although the legislation that the Committee is now considering would establish a Small Business Lending Fund (SBLF) outside of the TARP, the SBLF is intended to complement the TARP, and it is a close relative of TARP initiatives such as the Capital Purchase Program. As such, I believe that the Panel's perspective may be valuable.

The Congressional Oversight Panel has taken no position on whether any of the programs discussed in this testimony, including the SBLF, should be implemented.

**Introduction**

Small businesses have long been an engine of economic growth and job creation in America. More than 99 percent of American businesses employ 500 or fewer employees, and together these companies employ half of the private workforce and create two out of every three new jobs.

Credit is critical to the ability of most small businesses to purchase new equipment or new properties, expand their workforce, and fund their day-to-day operations. If credit is unavailable, small businesses may be unable to meet current business demands or to take advantage of opportunities for growth. This could choke off any incipient economic recovery.

Unfortunately, small business credit remains severely constricted. Data from the Federal Reserve shows that lending plummeted during the 2008 financial crisis and remained sharply restricted throughout 2009. Although Wall Street banks had been increasing their share of small business lending over the last decade, between 2008 and 2009 their small business loan portfolios fell by 9.0 percent, more than double the 4.1 percent decline in their entire lending portfolios. Some borrowers looked to community banks to pick up the slack, but smaller banks remain strained by their exposure to commercial real estate and other liabilities. Many small businesses have had to shut their doors, and some of the survivors are still struggling to find adequate financing.

Although the small business credit crunch is partly caused by the reluctance of banks to lend, it is exacerbated by the reluctance of businesses to borrow. A small business loan is, at its heart, a contract between two parties: a bank that is willing and able to lend, and a business that is creditworthy and in need of a loan. Due to the recession, relatively few small businesses now fit that description.

During the Panel's recent field hearing in Arizona, a local bank president laid out the problem in stark terms:

“We could grow the bank by \$100,000,000 in new assets and not need any new capital.... Our lack of loan growth is a reflection of the impact of the recession on the small businesses in this state.... We would do more, but it is difficult to find anyone who has not been impacted and remains creditworthy.”

Another concern is that the current regulatory climate may make it extremely difficult for banks to increase their small business lending. There have been anecdotal reports that bank examiners have become more conservative and have required increasing levels of capital in the last year. The balance between sufficient regulation and over-regulation is a fine one. In an overly permissive regulatory environment, banks may tend to make riskier loans, exacerbating the economy's precarious position. In an overly restrictive regulatory environment, however, banks may become too conservative, and there will be insufficient credit available to help pull the economy out of the recession.

### **The TARP and the Capital Purchase Program**

Treasury has launched several TARP initiatives aimed at restoring health to the financial system, and the Panel evaluated the impact of these programs on small business lending in our most recent oversight report, "The Small Business Credit Crunch and the Impact of the TARP." After a thorough review, we found little evidence that these programs have had a noticeable effect on small business credit availability.

Among the TARP initiatives announced to date, the program that most closely resembles the proposed SBLF is the Capital Purchase Program (CPP), which provided a total of \$204.9 billion in capital infusions to banks. In exchange, the government received preferred stock paying a 5 percent dividend, as well as warrants for the purchase of common stock. The bulk of CPP funding, about 81 percent, went to large banks with over \$100 billion in assets.

The impact of the CPP on small business lending is extremely difficult to measure. One issue is that the definition of "small business" varies widely, meaning that different data sources on small business lending are often not directly comparable. Further, Treasury required only the top 22 CPP recipients to report on their lending activity. Even for these institutions, relevant data is available only from April 2009, when Treasury first required reporting of small business lending, until January 2010, when the institutions began to exit from Treasury reporting requirements upon repaying their CPP funds.

Within this narrow window, it is clear that small business lending was on the decline. The average small business loan balance for these institutions decreased 4.6 percent from April 2009 to November 2009. Total small business originations for these institutions decreased by 7.4 percent for this same period. Although it is possible to question whether lending levels might have decreased further absent the CPP, there are no data to support or challenge this assertion.

The lack of data available to evaluate the CPP illuminates a broader problem: the absence of high-quality data about current lending practices. The Panel believes that Treasury's currently limited data collection is at best regrettable. Such poor data have made it far more difficult to pinpoint the causes of today's problems and, as a result, to find effective solutions.

### **The Small Business Lending Fund**

As presently proposed, the SBLF would provide \$30 billion in low-cost capital to small- and mid-sized banks. Banks would be eligible for the SBLF only if they hold less than \$10 billion in assets. The goal is to reach the relatively small financial institutions that provide a disproportionately large share of small business credit.

The core of the SBLF program is an incentive for banks to increase lending. The SBLF would, like the CPP, require recipients to pay a dividend on their borrowed money – but unlike the CPP, the SBLF would link the dividend rate to the recipient's lending activity. Participating institutions would pay a dividend of 5 percent, which could drop as low as 1 percent if the bank “demonstrates increased small business lending relative to a baseline set in 2009.” On the other hand, if the bank's lending rate decreases or plateaus after two years, the dividend rate would rise to 7 percent. At the end of this five-year period, the dividend rate would increase to 9 percent, which would provide an incentive for banks to repay the funds. This dividend structure is intended to ensure that SBLF recipients, unlike CPP recipients, actually increase their lending to small businesses.

The SBLF's prospects are far from certain. Even if it is established by Congress immediately, it may not be fully operational for some time. It could arrive too late to contribute meaningfully to economic recovery.

Moreover, banks may shun the program in order to avoid the stigma of government funding. Assistant Secretary Allison recently testified to this committee that small banks have faced pressure from competitors that use the “‘TARP recipient’ label in negative advertising.” In addition, industry sources have told the Panel that restrictions that were applied after banks accepted TARP funds have made banks hesitant to participate in the TARP, as they have no guarantee that the restrictions in place will remain constant. It is possible that concerns over these issues could carry over to the SBLF.

Banks may also avoid the SBLF if they are unwilling to take on new liabilities during troubled economic times. In particular, the Panel recently reported that 2,988 banks nationwide were classified by their regulators as having a potentially risky concentration in commercial real estate (CRE) as of March 2010. As long as CRE and other assets remain in jeopardy, banks may be unwilling to increase their small business lending, notwithstanding the SBLF.

The SBLF also raises questions about whether, in light of the CPP’s poor performance in improving credit access, any capital infusion program can successfully jump-start small business lending. The SBLF rests on the assumption that the key factor constraining lending is that banks do not have enough money to lend. However, another major constraint is the unwillingness of small businesses to borrow. In the fourth quarter of 2008, net 57.7 percent of the respondents to the Federal Reserve Board’s Survey of Senior Loan Officers reported that demand had fallen for small business loans – a figure that rose to 63.5 percent the following quarter. Even now, net 9.3 percent of the survey respondents continue to report falling demand. To the extent that contraction in small business lending reflects a shortfall of demand for credit rather than of supply, any supply-side solution that relies on improving bank balance sheets, such as the SBLF, will fail to gain traction.

An additional risk is that the SBLF may reward banks that would have increased their lending even in the absence of government support. The SBLF’s incentive structure is calculated in reference to 2009 lending levels, which were low by historical standards. If a bank increases its lending – not as a result of receiving the SBLF funds but simply to return to a more normal lending level commensurate with its long-term business model – then it will receive a reduced cost of funds. The low lending levels in 2009 also make it unlikely that the penalty provision

will be triggered. In effect, a bank may receive a government reward and avoid a penalty simply for acting in its normal course of business.

Even if the SBLF's incentive is sufficiently strong, the program may produce one key unintended consequence. A capital infusion program that provides financial institutions with cheap capital along with penalties for failing to increase lending runs the risk of creating moral hazard by encouraging banks to make loans to borrowers who are not creditworthy. The stronger the incentive, the greater the likelihood that the program will spur some amount of imprudent lending activity. Treasury maintains that this concern is minimal, as the SBLF was designed to minimize the chances that banks will use the capital to make risky bets. The program does not shift risk away from the banks that receive the capital: any institution that receives funds under the SBLF is obligated to repay that money to Treasury and therefore will lose money if it makes a bad loan. The dividend and repayment requirements are likely to decrease the chances that banks squander the capital on imprudent lending.

### **Alternatives to the SBLF**

One alternative to the SBLF that the Panel explored in our most recent oversight report would be to permit banks to fund state lending consortia, such as those that exist in New York and South Carolina. The New York Business Development Corporation (NYBDC), for example, uses funding from member banks to make loans to small businesses, "many of which do not meet the requirements for traditional financing." Because of the single-purpose nature of consortium lending, this approach may be effective for deploying capital directly into new small business loans, rather than using it to shore up a bank's balance sheet. A consortium could also leverage contributed capital several times over.

This option would be most effective if it included an incentive that encourages banks to provide funds to consortia. For example, just as the SBLF's lending incentive primarily rewards banks based on the loans they make, a consortium-oriented approach could employ an incentive that rewards banks for their contributions to a consortium.

Any effort to spur small business lending through consortia would, however, face several obstacles. Lending consortia are currently active in only a handful of states, and starting programs from scratch in other states might take a substantial amount of time. As a result, any consortia-based approach might have limited reach, especially in its early stages. Today's witnesses from Michigan will, no doubt, be able to shed more light on this subject.

## **Conclusion**

Treasury has stated that it believes that providing cheap capital to the smaller banks will unlock the credit that CPP did not. It is true that the SBLF, unlike the CPP, provides incentives for banks to lend, which may result in a different outcome. In many ways, however, the SBLF substantially resembles the CPP: it is a bank-focused capital infusion program that is being contemplated despite little, if any, evidence that such programs increase lending. Had Treasury gathered more consistent data, including ongoing data from the top 22 CPP recipients, it might have been possible to have a complete basis of comparison for lending by these institutions since EESA was enacted. In the absence of that data, the Panel is skeptical that Treasury has the grounds on which to make such an assumption. After all, the largest CPP recipients did not lend more. Further, the SBLF imposes only a mild penalty on banks that take the funds but fail to increase lending, and there is nothing in the SBLF to create accountability or linkages between the receipt of funds and loans, something that even some small banks have said that they would welcome.

The Panel recommends that Treasury and the relevant federal regulators:

- Establish a rigorous data collection system or survey that examines small business finance in the aftermath of the credit crunch and going forward. The Federal Reserve Bank of Atlanta has commenced a demand-side survey, for example, that could potentially be expanded to other Federal Reserve banks. Such a survey should include demand- and supply-side data and include data from banks of different sizes (both TARP recipients and non-TARP recipients), because the lack of timely and consistent data has significantly hampered efforts to approach and address the crisis;

- Require, as part of any future capital infusion program, reporting obligations that would make it easier to evaluate whether the support provided by the program actually has the capacity to achieve the hoped-for results;
- As part of its consideration of small business lending, evaluate whether a capital infusion program is likely to have the effect of increasing lending, and is therefore worth pursuing;
- Consider specifying minimum standards for underwriting SBLF loans in order to be sure that the incentives embedded in any program do not spur imprudent lending; and
- If the SBLF is to be pursued, evaluate whether the SBLF can be implemented quickly enough to make any difference at all, particularly given that announcements followed by inaction may negatively affect the market.

Because small businesses play such a critical role in the American economy, there is little doubt that they must be a part of any sustainable recovery. It remains unclear, however, whether Treasury's programs can or will play a major role in putting small businesses on the path to growth.