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House Small Business Committee
"Condition of Small Business and Commercial Real Estate Lending in Local Markets"
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Chairman Frank, Ranking Member Bachus, Members of the House Financial Services Committee, Chairwoman Velázquez, Ranking Member Graves, and Members of the House Small Business Committee, thank you for the opportunity to testify today.

The challenges facing small financial institutions, commercial real estate, and small businesses throughout the country are critically important and I appreciate your commitment to working with the Administration in seeking methods to alleviate the strain felt by these institutions.

The Administration believes strongly that small businesses and the community banks that finance those businesses are critical to our economic recovery. Over the past 15 years, small businesses have created roughly 65 percent of the new private sector jobs in America. Small businesses are an important part of our local communities and have a meaningful impact on job growth and productivity.

The Administration has adopted a wide range of measures to stimulate economic growth and promote liquidity in the credit markets. Treasury has strived to protect the health of smaller financial institutions throughout the implementation of the TARP. The very first, and largest, program implemented under TARP, the Capital Purchase Program

(CPP), was designed to provide capital to financial institutions of all sizes.

Treasury has invested in over 650 small and medium-sized financial institutions through the Capital Purchase Program (CPP). By providing capital, Treasury has helped these institutions absorb losses from bad assets and continue to provide financial services to businesses and individuals. Most small banks extend the majority of their business loans to small businesses and provide these loans in a higher proportion of overall business lending than larger financial institutions. Moreover, because most small businesses cannot directly access the capital markets, many have few other options for financing outside of bank loans, making community banks that much more critical to the future of these businesses. These capital programs have been effective and our financial system is more stable because of them.

Treasury also took steps to improve the health of securitization markets, which provide key avenues of credit for small businesses, by facilitating the purchase of SBA-backed securities under the Term Asset-Backed Securities Loan Facility (TALF). TALF has helped spreads on asset-backed securities (ABS) come down by 75% on average. ABS is an important component to providing consumer and business financing.

Additionally, the American Recovery & Reinvestment Act is driving expansion of economic activity and has provided targeted efforts to support small businesses. The legislation cut taxes for small businesses, allowing them to write off more of their expenses and to earn an instant refund on their taxes by `carrying back' their losses five years instead of two. The Recovery Act also temporarily raised the SBA maximum guarantee and eliminated certain fees on eligible SBA loans.

Though we have seen signs of improvement in the credit market, there is also a need for further steps to make credit more available. Small businesses continue to face challenges accessing credit and the data show there has been a broad-based decline in lending. On February 23, 2010, the FDIC reported that lending by the banking industry fell by $587 billion in 2009, the largest annual decline since the 1940s. While the latest data indicate that the pace of tightening has slowed, the Fed Senior Loan Officer Survey has shown net tightening for small business borrowers for 13 straight quarters.

During periods of extreme economic stress, market uncertainty rises, driving institutions to review their lending practices, tighten underwriting standards, and review their capacity to meet demand. Small banks, in particular, are facing uncertainty over their commercial real estate assets that may prevent them from lending more to their small business customers.

The effects of the real estate market downturn have also hit small businesses particularly hard. Approximately 95% of small employers own at least one of the following three types of real estate: (i) a primary residence, (ii) their business premises, or (iii) investment real estate. Approximately 76% of small businesses occupy commercial real estate, either as owners or renters, the value of which has declined by 50% or more in some cases. Depressed values have damaged balance sheets and hurt their access to collateralized credit, even if their businesses are otherwise strong.

The federal banking regulators recently issued guidance on small business lending that should yield greater consistency among the agencies and help banks provide prudent small business lending.

Ultimately, it is critical to recovery that we ensure adequate credit availability for small businesses. For this reason, the President recently proposed a new $30 billion Small Business Lending Fund (SBLF). Under our core proposal, the SBLF would support lending among community and smaller banks with assets under $10 billion. Banks with less than $1 billion in assets would be eligible to receive capital investments up to 5% of their risk-weighted assets. Banks between $1 billion and $10 billion in assets would be eligible to receive capital investments up to 3% of their risk-weighted assets.

The proposed design of this new program would provide a clear economic incentive for smaller banks to increase small business lending – as their lending increases, the dividend rate payable to Treasury gets reduced, to as low as 1% for banks that increase lending by 10% from a baseline set in 2009. Additionally, our investment could be leveraged to increase lending by considerably more than the $30 billion we dedicate to the facility.

The Administration’s proposal would, through legislation, create a new facility to support small business lending. To encourage participation, the SBLF would be separate and distinct from TARP and participating banks would not be subject to TARP conditions. Indeed, while Treasury has the existing authority and funding today to create a small business lending facility under TARP, we are convinced that if we did so, the number of small and medium-sized banks willing to participate would decline dramatically.

Previous TARP programs may have seen reduced participation as a result of several factors, including certain statutory restrictions. Smaller institutions, in particular, have struggled with the executive compensation restrictions that are the same for all institutions, regardless of size. While the imposition of restrictions by Congress on institutions receiving assistance under EESA was entirely appropriate, the fact that the statute requires uniform application of such restrictions has presented challenges for program implementation. This creates a situation where, for example, a small community bank may not be permitted to make severance payments to a bank teller or secretary due to the "golden parachute" prohibition that applies to senior executives and the next five highest-paid employees. Banks with few employees wind up disproportionately affected.

Moreover, after conducting extensive consultation, our view is that even if we removed some of the restrictions described above, many lenders would decline to participate due to a belief that a "stigma" is associated with the TARP program. This belief – as well as fear that by virtue of being a TARP recipient, an institution could be subject to retroactive disadvantages, such as exclusion from future Congressional tax relief available to non-TARP recipients – would likely have the impact of discouraging participation in the program even if the lender might otherwise have taken part.

We have already seen the impact this stigma can have on participation among smaller banks, as many banks cited fear of association with TARP as a reason for withdrawing their applications from the Capital Purchase Program. In some cases, we have even heard reports of certain financial institutions attempting to call a competitor's soundness into question by featuring the "TARP recipient" label in negative advertising – even though institutions receiving an investment through the Capital Purchase Program, for example, have been required to receive a viability determination from their primary federal regulator to participate.

For these reasons, the Administration strongly believes that a small business lending plan outside of the existing TARP, accompanied by strong oversight, would draw the greatest participation by small financial institutions and thus have the greatest chance of success.

Small businesses are asking for our help. The Small Business Lending Fund would be a significant step toward addressing their concerns. Treasury looks forward to working with Congress on this proposal to help small businesses generate jobs and support a full economic recovery.