TESTIMONY OF

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On

THE IMPACT OF THE CREDIT CRUNCH ON SMALL BUSINESS

Before the

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

UNITED STATES SENATE

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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

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[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.

<u>Massachusetts Small Business Capital Access Program ("CAP Program")</u>

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.

<u>Microloan Loan Program</u>

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.