HEARING ON ACCESS TO CAPITAL FOR SMALL BUSINESS

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WEDNESDAY, MAY 17, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:21 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo (Chairman of the Committee) presiding.

Chairman MANZULLO. Good morning. This hearing will now come to order. On behalf of the members here today and myself, I welcome our witnesses, and thank you for your participation in this hearing.

This hearing is on capital, which is the lifeblood of small businesses. The testimony from the witnesses today will center on some very interesting issues, such as whether or not in this three-legged stool, it's lack of demand, whether or not it's inflation, or fear of inflation, or whether or not the banks themselves simply are not interested in lending money. And Dr. Ferguson, I'm sure, will have all the answers to those questions because I do not care how much we get into the issue of available capital we get into the theoretical realm, and sometimes that is about as far as we could take it.

We are going to take a look at why the Federal Reserve decreased interest rates. We will look at how federal and private policies affect non-governmental lending and whether small businesses are accessing necessary credit and capital through private lending sector in the recent slowing economy. So, it is going to be a very interesting hearing.

Our Subcommittee Chairs, DeMint and Toomey, I commend them for their work in the area and their anticipated joint subcommittee hearing and legislation. Mr. DeMint and Mr. Baird are developing to bridge the gap medium-sized businesses have and access in capital investment.

It is my distinct pleasure to recognize, after the opening statement from Mrs. Velazquez, the Federal Reserve Vice-Chairman, Dr. Roger W. Ferguson, Dr. Jr. Ferguson took office October of 1999 as Vice-Chair of the Board of Governors of the Federal Reserve for a four-year term ending October 5, 2003. I will further elaborate on his distinguished record before he testifies, but first I will recognize my friend, the Ranking Member from New York, for any statement that she may wish to make.

Ms. VELAZQUEZ. Thank you, Mr. Chairman, and welcome, Dr. Ferguson.

Access to capital is one of the critical components to business success. A business that can obtain funding quickly and at a reasonable cost has a much greater chance of succeeding. Unfortunately, for many small businesses, getting access to cash flow is not always that easy. One only needs to look at the fact that the vast majority of business start-ups are done not by conventional loans, but by credit cards to realize this.

Make no mistake, lending for business start-up and expansion is very much a high-risk—high reward venture. I believe that many of our financial institutions are looking for innovative ways to assist small businesses to obtain the funds they need to start and grow their business.

Unfortunately, banks cannot do it alone. Not only do they operate at a time when federal regulators prod banks to tighten loan underwriting criteria—the must also operate in a new era created under Graham-Leach-Bliley that has spawned a very competitive environment for the deposit that make it possible for lenders to make loans.

Today, with so many different competing interests vying for those increasingly scarce funds, it is no wonder both lenders and borrowers are frustrated. This is where the SBA loan programs come into play, with their ability to guarantee funds that allow banks to set aside less of their scarce deposits and maximize their lending potential.

By doing this, we increase the ability of our financial institution to offer loan opportunities for small businesses. This partnership has been so successful that currently SBA loan programs account for 40 percent of all long term small business loans nationwide. It is because of this relationship that you cannot talk about access in the private lenders market without considering it within the context of SBA's loan programs.

That is why the proposal by the Bush administration to increase fees is not only harmful to our small business owners, but it is harmful to our lending system. time and time again when fees on these programs have been increased, the ability for banks to offer loans has plummeted. At a time when our economy is creating more questions than answers, we need a strong and well functioning guarantee loan system to ensure that our small businesses have access to the capital they need to survive.

In closing, it is clear that access to capital for small business is truly access to opportunity, which is why this committee has spent so much time working to ensure that our nation's small businesses can access the funds they need to start and grow their businesses.

I want to thank the witnesses for coming here today and I look forward to their testimony. Thank you.

[Ms. Velazquez's statement may be found in appendix.]

Chairman MANZULLO. Thank you.

It is my pleasure to introduce Dr. Roger W. Ferguson, Jr., Doctor in Law and Ph.D. He served as the chairman of a group of ten working party on financial sector consolidation formed in September of 1999 at the request of the finance ministers and the central bank governors of the G–10; holds a B.A. in Economics from Harvard University; Juris Doctorate in Law and a Ph.D. in Economics. He was a member of the board of McKinzey & Company, an international management consulting firm. From 1984 to 1997, Dr. Ferguson served as the director of research and information systems, overseeing a staff of 400 research professionals. From 1981 to 1984, he was an attorney with the New York City Office of Davis, Polk & Wardell.

Dr. Ferguson, welcome to the hearing today. We eagerly look forward to your testimony. Thank you.

STATEMENT OF ROGER W. FERGUSON, JR., VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. FERGUSON. Thank you, Mr. Chairman, and also Ranking Member Velazquez.

Chairman MANZULLO. I believe that you had wanted to read your complete statement which will be about seven or eight minutes so I am not going to put the five-minute clock on.

Mr. FERGUSON. Fine. Thank you very much. I appreciate that. And I do—I am pleased to appear before this committee to discuss the availability of credit to small businesses.

Before turning to the latest information on credit market conditions, however, I think it is important to highlight the special characteristics of small businesses that make them such an important part of our economy and at the same time create a heterogeneous set of financial needs and credit demands. Much of the information that we have on small business financing comes from surveys, including the Federal Reserve's Survey on Small Business Finance, the latest of which was completed last year.

No doubt I am preaching to the choir here when I tell this group how important small businesses are in our nation's economy. The statistics collected by the Census and Small Business Administration are indeed remarkable. These data reveal that there were more than 24 million nonfarm business tax returns filed in the United States in 1999. More than 99 percent of those returns were for small businesses, that is, firms with fewer than 500 employees. Roughly half of these were self-employed persons and about a third were part-time. Based on SBA estimates, small businesses employ more than half of the private work force and are responsible for around 50 percent of all sales and private gross domestic product, a share of output that has remained fairly stable over time.

With half of our nation's private, nonfarm output coming from small businesses, obviously our economic well-being depends greatly on this sector. But small businesses do more for us than can be captured in these statistics. Small businesses are a source of new ideas and products. The list of innovations developed by these enterprises in fields such as software, computer technology, aerospace, and pharmaceuticals is quite impressive. The possibility that an idea or new product will eventually transform a small business into a large corporation is a great motivator of change and risk taking. Beyond that, small enterprises make a huge contribution in the form of the support and synergies they provide operating side by side with large businesses.

An essential feature of a thriving small business sector is the ability of firms to start up, to grow, and to change ownership. Just as essential to the dynamism of our economy of these firms to downsize when that improves profitability or to exit the markets when the resources are more highly valued elsewhere. There is a tremendous amount of turnover of small businesses. In 1999, approximately half a million firms—excluding self-employed for which numbers are not available—closed for one reason or another—perhaps they merged or were acquired by a larger firm, perhaps they failed, or the owner found other reasons to move on. At the same time, more than half a million new businesses were created.

The continuous entry and exit of firms is a clear sign that resources are responding to shifting demands of consumers and businesses and to changes in the cost of production. The flow of labor and capital form less productive to more productive uses is the cornerstone of a dynamic and healthy economy. A downside of this churning is the greater uncertainty that attaches to the earnings and risk profile of each individual small business.

This has significant implications for the financing of small businesses. Indeed, while a number of factors need to be in place for a small business sector to thrive, including a mobile labor force and a sound infrastructure of laws and regulations, perhaps the most important ingredient is access to capital and credit.

The financing needs of small businesses are as varied as the population itself. The life cycle of a small business can take many forms, with very different implications for the types of risk and returns that lenders and investors can expect. For new ventures that have high risk profiles and high expected returns—as do many start-up firms in the tech sector—the initial stages require commitments of equity capital, sometimes from family and friends and sometimes in the form of venture or private equity capital. Further injections of equity are required in the early stages of growth and ultimately some form of so-called "take-out" financing is arranged, such as an initial public offering or a buyout by another firm, that allows a venture capitalist to extract his or her investment.

The past decade has been impressive for the large amount of equity capital that flowed to venture and high-tech enterprises in this country. The National Venture Capital Association estimates that investments in emerging enterprises totaled $214 billion over the past five years, and exceeded $100 billion last year alone. The number of companies funded last year was a record 5,300. About 270 companies that originally were backed by venture capital were purchased by other companies last year. Another 250 were able to go public through IPOs of stock, even as the market for publicly traded equity was in the initial stages of its recent decline.

The average age of firms going public was about seven years, but many were older, which is indicative of the potentially long-term commitments that investors in venture enterprises must be prepared to make. It is safe to say that the United States has been a role model for countries in Europe and Asia seeking to develop markets for equity financing for small businesses.

But for every new, high-growth firm seeking venture capital, there are hundreds of small businesses in the manufacturing, construction, trade, and service sector that have quite different financing needs. Some of these firms have established operating histories and marketable assets that make them good candidates for credit from conventional financial institutions.

A few are small corporations that have access to bond market financing, though their bonds are likely to be rated below investment grade. The vast majority are small enterprises with few assets to pledge as collateral and with only limited operating experience from which investors can assess operating performance and future earnings streams.

Recognizing the importance of small businesses, we endeavor to understand the sources and uses of credit by different sizes of firms. To this end, the Federal Reserve has undertaken three national surveys of small businesses, the first in 1987, the second in 1993, and the third which was completed last year. A detailed description of the latest survey, along with preliminary results, was published in the April 2001 Federal Reserve Bulletin. And this morning I will highlight just a few preliminary findings and note that the data have just become available for what promises to be interesting analytical work.

The survey sampled 3,600 small businesses that were representative of more than 5 million nonfarm, nonfinancial enterprises that operate for profit. It gathered information on a large number of firms, including each firm's use of credit; characteristics such as the number of employees, or the industry, or the age of the firm; and its income and balance sheet data as of year-end 1998.

The earlier surveys had been used, for example, to shed some light on the relationship between a business and its bank or primary lender and to study how financing choices varies with location, age, size or other characteristics.

This latest survey can be used to update these studies and to assess how small businesses may have altered their use of credit and financial services in response to technological and competitive changes in the financial environmental.

The preliminary survey results we have glimpsed so far are interesting as much for their consistency with previous surveys as for the changes they reveal. For example, despite the large amount of structural change and consolidation in the financial service sector and the improving accessibility of capital markets to many smaller firms, commercial banks continued to be the dominant provider of financial services to small businesses in 1998.

Of the 55 percent of small businesses that obtained credit from market sources or institutions, nearly three-fourths had some sort of credit arrangement, such as a line of credit, a loan, or a lease, with a commercial bank.

Finance companies served about 13 percent of small business borrowers, and leasing companies served about seven percent.

The survey results also confirmed the growing use of business credit cards by small businesses. About one-third of all small businesses, more than 50 percent of firms with 20 or more employees, had business credit cards in 1998.

We included questions on the survey about the problems small businesses considered to be most pressing. Small businesses in 1998 expressed concern about the quality, cost and availability of labor and about increased competition from larger, international and internet firms. Of note, financing was not high on their list of concerns.

It is not surprising that small firms were feeling the pressures of tight labor markets and increased competition. 1998 marked the seventh year of a robust expansion. Bolstered by a technology-led acceleration in productivity, real GDP growth averaged four and one-quarter percent in the latter half of the 1990s, and the unemployment rate had dropped to four percent by the end of the decade.

Aggregate indicators of credit availability were quite positive in the mid to late 1990s. Banks were generally easing credit terms, and business loans grew robustly at both large and small banks.

The surge in equity markets provided a welcome environment for firms going public for the first time, and firms carrying below-investment-grade bond ratings were able to issue bonds at historically narrow spreads over Treasuries.

While disruptions in global markets in 1998 raised risk premiums on junk bonds and bank loans and threatened a seizing up in financial markets, ultimately they did not derail the flow of credit, especially to smaller businesses.

Since the 1998 survey, the economic and financial environment has again changed, and this time in ways that are less conducive to risk-taking and leverage. It became increasing apparent over the course of last year that the pace of economic growth was slowing. Credit markets firmed, including bank lending, partly in response to concerns that a slowing economy would result in some deterioration in the financial well-being of businesses and their creditors. As corporate profits fell and businesses revised down their outlook for sales and earnings growth, investors became less certain about the returns they should expect on investments.

By late last year, equity markets looked considerably less attractive as a source of financing, especially to firms hoping to go public for the first time. The volume of IPOs dropped dramatically in the fourth quarter and remained sparse in the early months of this year, though it has not dried up entirely.

As prospects for takeout financing through an IPO became problematic, private equity investors became more cautious about committing capital to earlier stages of financing. While venture capital investments exceeded $100 billion last year, the pace of investment has slowed in recent quarters and there are reports that some young firms are finding it hard to get second- and third-stage financing for venture capital projects.

In the capital markets, the default rate on high-yield bonds climbed markedly last year to its highest level since 1991, boosting lender concerns about the ability of weaker firms to service their debt in this environment.

Yields on so-called junk bonds rose appreciably relative to those on better-rated debt. In consequence, the issuance of these high-yield bonds dropped sharply in the fourth quarter. Although the capital markets continue this year to exhibit considerable selectivity, the flow of credit through bond markets has been strong over all. Gross bond issuances or offerings by nonfinancial firms totaled nearly $160 billion in the first four months of this year. And, although they are paying higher risk premiums, non-investment-grade companies still are able to raise funds; junk bond offerings have accounted for about 25 percent of the gross issuance this year.

Are you aware, the Federal Reserve conducts surveys of senior loan officers at large banks around the country. These surveys ask about banks' credit terms and standards, about loan demand, and other issues that may be topical. During the market turmoil in late 1998, banks began taking a harder look at the loans that they make to large and middle market businesses.

While financial markets settled down subsequent to 1998, banks appear to have maintained a more vigilant posture. Last year, in an environment of rising delinquency rates on loans and indications of declining credit quality, the net percentage of banks who reported some firming in their lending standards for large and medium borrowers rose steadily in each of our surveys.

Anecdotal reports suggest that banks were particularly concerned about concentrations of risk in sectors such as telecommunications, where returns have dropped sharply, and in manufacturing and other sectors highly dependent on energy and petroleum-based inputs.

Banks also reported firming standards and terms on loans to small businesses, but to a lesser degree than for large firms. Normally, we expect small businesses to bear the first pulse of credit tightening. But the downgrading and unexpected shocks affecting large, investment-grade corporations have led creditors to rethink the relative risks of lending to large and small firms.

Banks have continued to tighten standards and terms on loans and credit lines this year. In our May survey, just over one-half of domestic banks reported tightening their standards on C&I loans to large and middle-market firms over the past three months, and 36 percent tightened standards to small firms over the same period. Most of the banks that had tightened continued to cite a more uncertain economic environment, a worsening of industry-specific problems, and a reduced tolerance for risk.

In their latest reports, bank loan officers also indicated that the demand for business credit has waned of late, largely owing to reductions in planned investments and diminished financing for mergers. Just as lenders are treading more cautiously as the economy slows, so too are borrowers. Caution is apparent even among small businesses.

Importantly, the small business surveys conducted by the National Federation of Independent Businesses in the first quarter revealed that only 13 percent of their surveyed members thought the current period was a good time to expand, roughly half the percent of a year earlier.

The small business who thought it was a bad time to expand cited unfavorable economic prospects and a poor outlook for sales. Of note, very few—only three percent of the April NFIB survey—mentioned financing costs as a reason that the current period was not a good time to expand.

Indeed, the recent NFIB surveys that most of the respondents have not found financing conditions to be particularly onerous to date, despite the more cautious posture of financial institutions and higher risk spreads. For creditworthy businesses, large and small, the cost of borrowing has declined with the easing of monetary policy, and the associated decline in lending rates since last fall. The prime lending rate has fallen over now two percentage points since the end of last year, and the average interest rate paid by respondents on the April NFIB survey was down almost one percentage point over the same period, to its lowest level in nearly a year.

While we may take comfort from the lack of angst expressed by small borrowers in the NFIB surveys, I expect that many risks small businesses have found credit a bit harder or more expensive to obtain. On the other hand, there are few signs of the types of financial headwinds that prevailed in 1990 and played havoc with the ability of many creditworthy small and medium firms to renew credit lines and roll over loans.

In contrast to that period, our financial institutions have had a long stretch of solid earnings growth during which to build capital and liquidity positions. In addition, although loan portfolios have recently begun to deteriorate, delinquency rates of businesses and real estate loans remain well below those of earlier periods. Commercial real estate markets, in particular, have not gone through the boom-and-bust excesses of the late 1980s and early 1990s.

So in sum, we have seen greater caution being exercised by both borrowers and lenders in credit markets recently. Such tightening might be expected in an economy that has slowed after several years of rapid expansion and debt growth. Much of the firming to date has been selective and directed toward companies perceived to face an uncertain future in the new economic environment and to leveraged companies that are vulnerable to a period of slowing sales and profits.

Overall, however, credit flows have been well maintained, and lending institutions are in a much better financial health than a decade or so ago. Importantly, reports from small businesses are relatively upbeat with regard to the availability of credit. Although risky borrowers face close scrutiny, banks apparently have continued to accommodate the needs of their creditworthy business customers, while bank lending rates, on average, have moved lower.

Mr. Chairman, thank you very much for your attention.

[Mr. Ferguson's statement may be found in appendix.]

Chairman MANZULLO. Well, I want to commend you on your clarity of the presentation, Dr. Ferguson.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Dr. Ferguson, the merchant banking proposal, as initially proposed, will have four financial holding companies that either own or invest in small business investment companies to deduct 50 percent of the total value of their investment from TO–1 regulatory capital.

As I understand, however, in issuing its revised capital proposal for nonfinancial equity investment, the regulators created a carveout for SBICs.

Would you please describe to this committee exactly how the new capital proposal would apply to SBICs?

Mr. FERGUSON. Okay. If you would give me—yes, I would be happy to describe it.

Graham-Leach-Bliley, as you know, allows—as you have described it—does allow bank holding companies to make equity investments without an SBIC license. And banks may elect to either have an SBIC, but they cannot invest directly. The holding company can invest directly or through an SBIC.

It is important to know, by the way, that the SBIC activity predates Graham-Leach-Bliley, as you observe.

Now, you raise a very important issue with respect to capital, and that was one of the most important issues that we faced implementing Graham-Leach-Bliley, because we wanted to set capital requirements that were appropriate and recognized the will of Congress but also recognized the risk that might exist in merchant banking.

You are right to point out that the board originally or initially proposed a uniform 50 percent capital charge to all equity investments that were made SBICs. And then in debating this and listening to commenters, we discovered that there was a great deal of concern, as you have suggested, about this higher regulatory capital charge, and particularly, there was a concern that this would perhaps reduced the commitment of banking organizations to SBIC financing.

Ms. VELAZQUEZ. Yes.

Mr. FERGUSON. And so what we have done is we have listened to, as you observed, the commenters and moved a bit in that direction. And so we believe, with the new proposals with respect to capital, that we will have a relatively level playing field, that we will not tip banks' preferences away from the SBIC, but at the same time we believe that the risks that are inherent in merchant banking, and there are some, would also be appropriately recognized by these capital standards.

And so I think, if I can sum up, we started with one perspective. We listened to commenters. We recognized the will of Congress. We recognized the importance of SBICs which predated Graham-Leach-Bliley, and I think we have now moved to a position where there will be an appropriate balance between SBIC financing and non–SBIC financing while the risks that are inherent in merchant banking, and we believe there are some, will be appropriately recognized with respect to capital.

Ms. VELAZQUEZ. Thank you. I am happy to hear that.

In the March 2001 Federal Reserve survey, 43 percent of the banks that responded reported that they tightened their credit standards. This was about the same percentage of banks that reported tightening their standards in the January 2001 survey.

However, the result of a recent survey conducted by the FDIC shows that about the same percentage of financial institutions are loosening their commercial credit standard as are tightening them.

What do you make of this mixed survey results?

Mr. FERGUSON. I think you are right to point out that there are mixed survey results, and I would add to that, for example, the set of surveys from the NFIB that suggested small businesses do not put credit concerns as high on their list.

I believe a number of things are emerging here. First, we should put this in an historical context. In 1998, banks started to tighten because we had had a period in fact in which they had been loosening their terms and conditions, and some of their credit standards, and perhaps as they looked at the turmoil that emerged in 1998 and the risks that became earlier in 1998, they decided it was appropriate to readjust and move their standards back to the direction of a bit more tightening, but again, from a very low base.

I believe that one of the things that we are seeing is that banks are still prepared to lend to their most creditworthy customers. I think they are tightening their terms and conditions somewhat over what had existed in 1998, but that has been a long-term process, several years now, and it came after a period in which they had been easing and credit had been expanding relatively rapidly.

I sense that one of the other things that we are seeing is that in a period in which interest rates have been coming down, we have seen the prime rate come down, for example, and so there are a number of different factors that are emerging where the pricing may be moving down to a more attractive range because of decreases in prime rates while banks are, if you will, sharpening their pencils with respect to understanding the real business prospects of the counterparties that come forward with proposals or requests for credit.

I think we are also seeing one other thing, which is—that is a supply story. There is also a demand side story which I have tried to indicate, which I think some businesses are deciding that their demand for capital have been reduced as their prospects become a little less certain.

Ms. VELAZQUEZ. However, there have been so much discussion of our credit crunch, and some people are blaming the regulators. When do you first notice a trend of creditors tightening their commercial loan standards?

Mr. FERGUSON. First, I do not believe that we are in the midst of a credit crunch nor do I think we face one.

As I have said, we first noticed this tightening of credit standards back in 1998, so this was not a recent trend. And as I said, it came off of a period in which standards had been eased quite noticeably.

And so to some extent we are getting the return to standards that reflected that perhaps earlier the standards were not as tight as they could have been.

But I want to return to what I had said originally, which is I do not believe that we are in the midst of a credit crunch. I think that set of phrases or comments strikes me as not accurately reflecting reality.

We also are coming off of a period when banks have had very good profits and profitability, when the credit capital cushion within banks is quite firm, and I believe that they will continue to lend when they see creditworthy customers.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman, and thank you, Dr. Ferguson, for your testimony today.

Some of the data that you refer to in your testimony suggests perhaps more encouraging news than I would have anticipated.

When I reflect on my own personal experience as a small business owner, one of the issues I am concerned about are those companies that are too small to attract the interest of venture capitalists generally, but are nevertheless often shunned by banks, in part because they may be in an industry that has a high failure rate. Therefore, banks tend to simply refuse to lend to the industry en mass.

An example is an industry that I have been in for a number of years, the restaurant industry. Many family-owned restaurants, small restaurants, start-up restaurant companies will go to banks who will simply say, you know, really you seem like a very nice person and you have got a great track record, but we have a categorical policy of not lending to restaurant companies.

It strikes me that a more, perhaps a better policy would be to lend at much higher rates, to have some greater compensation to offset the added risk. And I am wondering if we have any—if our regulation, if our regulators, if through either implied or explicit policies, we discourage lending that might make good sense if it were—you know, if the rewards were commensurate to the risk because I do see this problem for these categories of companies.

Could you comment on that?

Mr. FERGUSON. Well, sir, I would hope that there is nothing in the regulatory environment that discourages appropriately priced lending to creditworthy counterparties. As an economist and also as a regulator, I firmly believe that a modern capitalist society works best if all creditworthy borrowers have access to credit at prices and on terms and conditions which reflect accurately the risks associated with those institutions and their prospects as both they and their potential lender perceive those prospects.

Now, I think a number of things do happen. Sometimes potential borrowers and potential lenders do not perceive the prospects of a credit as being exactly the same, and so there are sort of disappointments that do emerge. But I would think what are focusing on in the regulatory community is to have access to credit that is fair, that is equitable at prices that reflect the underlying risk.

One of the things that we have been heavily focused on, particularly with respect to the larger institutions, for example is a much more risk-sensitive risk-based approach to capital. We are encouraging all institutions, large and small, to have the most modern, sophisticated risk management technologies and capabilities in order to in part answer that question.

The other thing I would point out is while it is appropriate, and we have appropriately recognized the very important role that commercial banks play with respect to lending to small enterprises. There are a number of other avenues to capital for small businesses, and I'm not speaking of venture capital, but we also know, for example, that trade credit is used by about 60 percent of small businesses. Obviously there is also in some cases credit card capabilities, lending from owners and others.

And so while it's appropriate to look at banks because they play a very important role with respect to credit, they are not the only source of credit for small businesses.

So I guess in summary I would say what I would hope we accomplish as regulators is to have banks and others extending credit on terms that reflect risk, looking on a case-by-case basis, and then also we have in our society a range of sources of capital as well.

Mr. TOOMEY. I do not disagree with anything you are saying. I am just wondering if that is really working, when banks, many banks in a given community will take entire industries and simply categorically refuse to lend to them. It strikes me that that is not a rational pricing. There ought to be some price at which some of the banks would lend.

Mr. FERGUSON. Sir, I agree with exactly your last point, which is that if it is not rational, as you observe, if there is a positive rate of return to be gained by extending credit to individual institutions, to individual counterparties, then banking or another institutional step in and undertake an effort do that.

Now, it may not be as quick as we would like, and let me add one other thing that has happened. We have seen during this period of our survey that the lines of credit outstanding to small enterprises has been going up. I attribute that in part to the fact that we have, for example, the ability to do banking through the internet and other technologies, the adoption of credit scoring models for banks for small businesses, which allow banks to make finer differentiations.

And so I agree with you, if there is a rational behavior because we have a free market system eventually there will be an institution that wants to come in and lend appropriately and new technologies that are allowing for better distinctions.

I should be clear, I do not think that regulators should try to micro manage lending decisions and encourage banks to make decisions that they would not otherwise make, but we should keep the banks' eyes focused on the fact that they have an obligation to intermediate, and that is their purpose for being, and that they should make risk-based judgments about their counterparties.

Mr. TOOMEY. Thank you.

Chairman MANZULLO. Thank you, Mr. Toomey.

Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman.

Two things: I found, Mr. Chairman, the report by the Federal Depository Insurance Corporation pretty interesting because their data is every six months. It brings us pretty much up to date in all the areas, from agriculture to construction loans, to credit card loans.

But credit card loans, what about the cost? You talk about that on page six, there has been an increase in business credit loans. Is that not kind of expensive, Mr. Ferguson?

Mr. FERGUSON. Well, what I have said on page six is that there has been an increase in the use of credit cards. I should be clear. Credit cards are used for a number of different purposes.

Mr. PASCRELL. Right.

Mr. FERGUSON. To some extent, for loans, I'm sure for some, but also there is some advantages that come with credit cards in terms of cash management and recordkeeping, et cetera. So we should be careful about jumping to that conclusion too quickly.

With respect to your question, as I have said, there are a number of ranges of opportunities for capital to exist. Yes, it is absolutely true that credit card interest rates are higher than some other interest rates, but the obligation, if you will, of the business person involved to look at the range of credit options open to them, commercial bank, lending, trade, credit, lending from other financiers of one sort or another, including for some venture capitalists, loans from owners, and figure out how they want to optimize that mix.

And if a business owner decides that given his range of options and opportunities some use of loans that are accessed through a business credit card or through a personal credit card is part of what they think is appropriate for running their business, then I think that's a rational business judgment that should be made.

You are right to talk about the pricing differential, but we should be very careful not to think that most small business credit comes through that channel since in fact we know that's not true.

Mr. PASCRELL. I am also concerned about when there is a slowdown in the economy, those smaller, more vulnerable companies will find somewhat of a tightening in basic market that they are into in terms of getting capital or access to capital that they may use be incurred or they may on their own—I think you know where I am heading—to use a credit card which is going to put them more in jeopardy.

And what is your reaction to that? I mean, should we discourage such?

Mr. FERGUSON. Well, I think we should do a number of things. First is—again, this will harken back to what I have said here, we should first look at the facts of the current situation when, indeed, we are having an economy that is growing below potential, but what we are hearing from small businesses is that they do not believe that their access to credit has dried up.

We have also seen that, just as the terms and conditions have tightened a little bit or some, I shouldn't—from where they were in 1998, they have tightened from where they were in 1998 for sure, the pricing has also changed as we have had an interest rate environment in which interest rates have been coming down.

Secondly, I do think we should encourage banks to look at each applicant that comes to them on a case-by-case basis, trying to understand as best they can the prospects for sure, and then price appropriately.

I think if there is a sign that banks are not lending through one channel but encouraging lending through another channel, then I think that is not—that is not necessarily the best approach for the way a bank should use its capabilities.

Mr. PASCRELL. How do we know whether that is the case or not?

Mr. FERGUSON. It is very hard for us to know with the data that we have. I think we can figure it out to some extent through the channel, through the information that comes from the NFIB, for example, which does not show that that seems to be emerging.

Now, we will find for some individuals they make a prospective judgment of their prospects and decide that they temporarily want to take on slightly higher credit card debt because they have an optimistic view that going forward they will have a position to pay that debt down.

And I think one of the things we do want to do is we want to educate all potential lenders—potential borrowers, be they small businesses or otherwise, to the appropriate use of various credit card channels or various card channel, I am sorry, credit channels. And one of the things the Federal Reserve has been doing is we have undertaken a very aggressive approach to its educating small businesses and others on their options and opportunities so that they do not make unwise business judgments.

Mr. PASCRELL. Yes, I think that is probably—to the Chair, that is probably one of the best kinds of advice you could give, particularly when this economy turns.

And my final question, Mr. Chair, if I may, do you see any contracting of the new venture businesses over the last six months?

Mr. FERGUSON. Well, as I said in my testimony, up through last year there had been record amounts of venture capital being made available, including last year about $100 billion. It has in fact come off some this year. We hear that from the National Venture Capital Association. There is anecdotal reporting. Even in today's Wall Street Journal there was an article about that. So it is quite clear that venture capitalists are again being somewhat more discerning, we will put it that way, with respect to their willingness to participate in venture capital activities.

Mr. PASCRELL. One final question, Mr. Ferguson. Things are tightening up in certain areas. Would you be so bold as to recommend to this committee and to the Congress should we be tightening up on the amount of money available through the federal government to guarantee loans, or should we be at this point expanding those opportunities, in your estimation?

Mr. FERGUSON. To be very honest with you, sir, I will not be so bold as to do that. [Laughter.]

You have asked the question in that direction, the answer is I will not be so bold as to do that. I will leave it to our elected representatives to decide how to use the taxpayers' money and to what you think of as the best advantage.

Mr. PASCRELL. Very good answer.

Mr. FERGUSON. That was a very good question, and I appreciate you for asking it. Thank you.

Chairman MANZULLO. Ambassador, I appreciate that answer. [Laughter.]

Ms. Napolitano.

Mrs. NAPOLITANO. I would say that is a very good dance. In fact, that was part of my question, is based on, especially in my state, in California, the economy has been sustained and increased because of small business, and the fact that small business availed themselves of SBA loans. And given the fact that we are looking at budget cuts in our programs in our agency, that is part of my question is will there be an impact? Do you foresee, and I am not asking you to speculate, I am just asking you as an individual who deals with the issue of small business day-in—or not day-in small business, but the economy itself?

And the question that goes with that is that has the Community Reinvestment Act been effective in increasing lending to low income and minority-owned business? And do you think it can be modified to be made more effective because most of the new businesses are women-owned businesses that are increasing as are minority-owned business?

Mr. FERGUSON. I would not, based on the facts that I have, and knowing that the Community Reinvestment Act was heavily looked at during part of the process of financial modernization, I certainly would not recommend any review of that at this stage. I think that was looked at very closely last year, and Congress came to some very wise compromises or some—that reflected the perspectives that Congress thought was best.

I think that what we will continue to find, as we have in the past, is that small businesses are an important part of our economy. We will find, I believe, that those that have credible business prospects will look from one source of capital to another, and I believe that we will continue to find that those are credible business prospects. We will continue to find some form of capital available. I cannot predict the pricing. I am not sure whether they will think it feels as though it is readily available.

And so in that sense, I believe that, as they have been in the past through many different ups and downs of the U.S. economy, small businesses have been an important part of the strength of the economy, and I expect that to continue going forward, and I expect access to capital to be an important issue with respect to them, but the evidence thus far is through a variety of different periods that businesses have—not all obviously, as I have said there is a great deal of churn—but businesses have in fact managed to continue to contribute at a relatively solid pace to the U.S. economy.

One of the points that I would clearly make, I made it at the very beginning, small businesses account for about 50 percent of the output in the U.S. economy, and that has been really a surprisingly steady finding that goes back to—the data that I looked at goes back to the fifties and sixties. It came down a little bit and stabilized at around 50 percent.

One of the implications I take from that is that as the economy goes through various cyclical changes still small businesses manage to hold onto their market and continue as a group to provide the same kind of impetus and momentum to the U.S. economy.

And so I take from that an optimistic message that small businesses have figured out a way to collectively, not each one, to do well.

Mrs. NAPOLITANO. Yes, but would that not put a damper on new entrepreneurship, which has really been the basis of some of our growth?

Mr. FERGUSON. No. As I said, we have not seen any dampening of new entrepreneurship. Despite the fact that small businesses have a very high churn, we find almost in any period a large number of businesses being started and falling off as well.

I gave a talk earlier where I talked about small businesses in 1990 and 1995, and let me just refer to that to tell you what we saw at that point.

What I saw at that stage was that, in fact, the number of small businesses in 1995 was about the same as it has been 1990, but there was a great deal of churn there. And so what that tells me is that there is no lack of entrepreneurial drive even as individuals look at the relatively risky world of starting a small business.

I believe that to be the case because I believe that many individuals, particularly with the educated population that we have, think that they have built up a large amount of what economists would call human capital, and that they often believe that the best way to get a return on that capital is to take the risk and start the business themselves, and I think that will continue.

Chairman MANZULLO. I appreciate it.

Mrs. Kelly, please. Thank you.

Mrs. KELLY. Thank you very much, Mr. Chairman.

I am a small businesswoman, and I am also on the banking committee, and I have been working on that banking committee to make sure that there is access to capital markets for small businesses. I am very concerned about that. And I understand, it is my understanding the primary sources of credit for most small businesses are commercial banks.

But I am interested in the small businesses who want to grow more substantially and raise funds in the securities market. Two main goals of the SEC are to increase consumer protections and to develop capital markets, as I understand it.

Do you think the SEC fulfilled this role with respect to the small businesses?

Mr. FERGUSON. I wish you had phrased the question differently.

Mrs. KELLY. Nope.

Mr. FERGUSON. To be very honest with you, I cannot say that I am an expert exactly on how the SEC has done its job, and I do not, in my position, really want to be in a position of either confirming or denying how well another agency has done.

Mrs. KELLY. So basically you are neither refusing but you also do not know?

Mr. FERGUSON. Yes, I am not refusing to answer your question. I am telling you truthfully that I have not done a detailed study of what the SEC has done, and therefore I feel very uncomfortable trying to give it an evaluation for you.

Mrs. KELLY. Mr. Ferguson, are you familiar with the changes to the SEC's Rule 504? Can you comment on them?

Mr. FERGUSON. No, I really cannot comment on the changes to the SEC's Rule 504.

Mrs. KELLY. Could you give us some information at a later date? Could you come back to us with assembled information on 504?

Mr. FERGUSON. Yes, that is a legitimate question. I will work with our staff to find what information we can on 504, and we will send you——

Mrs. KELLY. And get it back to my office, please?

Mr. FERGUSON. Yes. We will send you a letter on it, absolutely.

Mrs. KELLY. Thank you. I think it is extremely important to the access for capital for small businesses that we try to get that 504 rule working.

Mr. FERGUSON. Let me quite clear. I am not—you have asked a question that I think is quite legitimate. I just do not happen to have the answer here, but I will work with the staff to get an answer that we think is responsive to your question.

Mrs. KELLY. Thank you very much. Hope to hear from you soon.

Chairman MANZULLO. Doctor, we have got a vote on. I am going to waive my questions, and on behalf of the Small Business Committee thank you very much for appearing before us, and we appreciate your candor, we appreciate the simplicity of the words that you use in describing very terse economic terms, and I am sure we will have you back here. You have a warm welcome mat before this Committee.

Mr. FERGUSON. I have enjoyed this and I would say the Federal Reserve always tries to use straightforward words in describing complex terms. [Laughter.]

Chairman MANZULLO. Thank you, Doctor. Thank you, Ambassador.

Mr. FERGUSON. Thank you.

[Whereupon, a recess was taken.]

Chairman MANZULLO. We will get our second group of panels to take a seat.

I was thinking that maybe I should have asked Dr. Ferguson what is definition of "irrational exuberance" was, and I bet he would have found a diplomatic answer to that also.

Well, welcome back. Our first witness in our second panel is Dr. Bill Dunkelberg. He is currently professor of economics at the School of Business at Temple University where he formerly held the post of Dean and Director of the Center for Advancement and Study of Entrepreneurship.

Since 1971, he has also been the Chief Economist for the National Federal of Independent Businesses; served on President Reagan's transition team as an advisor to the Secretary of Commerce, and in 1989, was appointed to a two-year term on the Consumer Advisory Council of the Federal Reserve System.

Dr. Dunkelberg is the past president and fellow of the National Association of Business Economists, and elected member of the Conference of Business Economists, the National Business Economics Issues Council, and senior fellow at the Foreign Policy Research Institute in Philadelphia.

Welcome, Dr. Dunkelberg. We look forward to your testimony.

STATEMENT OF WILLIAM C. DUNKELBERG, CHIEF ECONOMIST, FEDERATION OF INDEPENDENT BUSINESSES

Mr. DUNKELBERG. Thank you, Mr. Chairman and Committee Members. It is a pleasure to be here this morning. Yes, it is still morning. That is good. I apologize, I have a written statement and will put that in the record, and there are a few little glitches in the——

Chairman MANZULLO. All the written statements will be admitted into the record, including the written statement of Vice Chairman Ferguson, and the members of Congress.

Please proceed.

Mr. DUNKELBERG. Thank you. You did not mention and I guess maybe I might not even have it on my resume, I am the founder of the small business "Made For Me dot com." We have widely dropped the "dot com" from our name. We are just now "Made for me." But the web site is up and we do use the internet and we are on our third capital raise now and doing very well. We make custom-made apparel which is an interesting business to be in, to say the least.

I also serve on the board of a bank, the largest fishing tackle manufacturer in the Your Honor, and the largest debt collector in the United States, so I have a lot of interesting perspectives on how the economy is doing and what it is doing.

In the discussion that we had——

Chairman MANZULLO. This is dead beat fish, is that right?

Mr. DUNKELBERG. Fish, that is right. I catch them with the best reel going.

The discussion of capital, we probably should distinguish between what we have characterized as kind of start-up capital versus the financing of an ongoing enterprise, and most of the discussion, I think, today in testimony has really been focused on the financing of ongoing enterprises, although we do keep mentioning venture capital and these kinds of things.

N.F.I.B. did a study back in the mid eighties of new firms that were members. We had about 5,000 members who had been in business less than 18 months, that is a new firm, and we followed the same firms for three years just to see how things were going.

And I should point out that virtually—that two-thirds of these people were financed basically by their own personal savings, median amount of capital expended by the first dollar in sales is about 20,000, and a quarter of those firms were started with less than 5,000 in capital. These firms are, of course, are typically not financed by banks. Banks are not by regulatory structure in the venture capital business, and really cannot take those risks.

I was interested in Mr. Toomey's comment about the restaurant business. Of course, one reason that banks, especially those 9,000 littler commercial banks that are out there, often do not lend in categories is there are not enough firms in the category to diversify your risk. If I loan you $100, it is an all or nothing deal. You either pay me or you do not. If I loan everyone in the room $100, then I understand what the risks are; most will pay, some will not. I know how to price the loan. And when banks do not understand how to price the loan, they cannot really make the capital available.

So mostly we will be talking about ongoing capital financing, that is, access to operating capital and some long-term funding and so on.

The NFIB began tracking information about the experience its members were having out in the economy back in 1973, when we started taking a random sample of then about 350–400 thousand member firms, now well over half a million. And in the first month of each quarter we would send out a questionnaire which contained a set of questions that I have outlined in my testimony that talk about experiences in the credit markets. And we have done that since 1973, and in 1986, we stated doing those surveys monthly.

And we have about—depends on your estimate of how many businesses are out there. We think about having 5 or 6 million employers in the United States. That is someone who pays social security tax on at least one person and we have then about one out of every seven employers as a member these days.

So even though we do not have every small business as a member, obviously the same economic forces that hit our members are hitting all the other members, and we can pretty much characterize through our surveys what is happening out there in the economy to the sector, this very important sector that Vice Chairman Ferguson pointed out produces about half the GDP and employs a much higher fraction of the private sector labor force.

So we started this back in 1973, and have a long history, and I have provided in my written testimony some graphics to show you what those look like, and I will just review the highlights very, very quickly.

One of the questions we ask is what is the most important problem facing your business today. We give them 10 choices plus a fill-in-the-blank, so we find out if things are changing.

So, for example, in the 1970s we included questions about energy cost and availability which maybe we should put back in now, but obviously disappeared as an issue, and we added instead insurance, the cost and availability of insurance.

But what I want you to see there is that since 1991 less than five percent of the firms have cited credit availability and cost as the major problem, and of course, the high was back in the earlier years of 37, so we get a lot of variance there, but as Vice Chairman Ferguson pointed out, we have not seen anybody really citing this as a major issue for their business for a long time now.

Another question we asked is about regular borrowing. We asked people about the loan rates that they pay and asked them to answer the question only if they borrow at least once a quarter. So we look at the percentage of firms who are actively entering the capital markets, and interestingly enough, that peaked out when the prime was at 21, and reached an all-time low when the prime was at six.

That does not say anything about our interest in borrowing whether the need to borrow back in the days when inflation eroded our cash flow at a very high rate, and of course unexpectedly. As we opened the back doors, inflation came in and we had to try to pass it on.

We had to do a lot of borrowing even at very high rates because survival depended on borrowing, but now borrowing activities have been at historic low levels for years and years, so our firms are much less frequently accessing the capital market on a regular basis.

To see how though the Fed is being, we have kind of our rough indicator question, which is, last time you got a loan was it easier or harder than the time before, so we get a sense of how the loan officers are treating them.

And then we look at the net percent of that and that is graphed for you there too and you can see the high there is around 27 percent, fortunately, a long time ago. It has been zero recently, in the last few years, and it has been running at less than five, net five percent saying harder since 1995.

So I would characterize the 1995 to 2000, right through now, 2001 period, as being one of the friendliest periods, friendliest capital market periods that small business has really experienced.

You will also note that—on the next chart—that the average interest rate we pay has fallen from 20 percent range down to 10 percent, which, of course, is very nice. I would call that particular cost of doing business has become much lower for us and we are very happy about that.

In terms of expectations, we say, well, do you expect credit conditions to get worse or better, to be tougher or easier, and that again has been very stable now for a long time, running at around minus five percent, which means five percent more said they expected to be harder than easier, but most people do not expect any change at all, so that number reflects really a very small number of people who expect credit conditions to change.

So you can see that really we have had very good capital market experiences since 1995, actually since—actually since 1983, when we finally started to get inflation and the economy in order. Once we had inflation rates down and a more reliable future and it became easier to run business and do very well, then capital markets responded accordingly by seeing less risk and of course making credit more available and at a lower price.

So overall our experience has been good, and right now we would—even with all the bad news we see about the economy, it is pretty clear from our numbers and for our half million firms that they still are not having problems getting the funds that they need. The price is still falling. That is great news. We like lower prices for the credit that we have and we really do not see any change in that in the foreseeable future.

So I will end my testimony there and take questions.

[Mr. Dunkelberg's statement may be found in appendix.]

Chairman MANZULLO. Thank you, Doctor.

Our next witness is Leslie S. Shapiro, President of Padgett Business Services Foundation. He is a graduate of the University of Minnesota with a Bachelor's and a Doctorate Degree from that institution; a member of several bars, including Washington, D.C. He was with the Department of Treasury and he was the executive director of the Joint Board for the Enrollment of Actuaries established pursuant to ERISA Act of 1974. He is the author of numerous articles, including "The Ethical Tax Lawyer: Is it an Oxymoron?" and he as a follow-up article saying, "Was the Tax Lawyer Unfairly Disciplined by Tyrannosaurs Rex in Jurassic Park?"

Mr. Shapiro.

Mr. SHAPIRO. Remind me to read that one sometime. [Laughter.]

STATEMENT OF LESLIE S. SHAPIRO, PRESIDENT, PADGETT BUSINESS SERVICES FOUNDATION

Mr. SHAPIRO. Thank you, Mr. Chairman, Ms. Velazquez. I am very pleased to be here this morning. As the Chairman said, I am Les Shapiro. President of the Padgett Business Services Foundation.

The Foundation is a entity within the structure of Padgett Business Services, a corporation headquartered in Athens, Georgia. Padgett has 275 offices located throughout the United States, providing accounting and tax services to principally small business entities.

We define a small business as one with under 20 employees. As a practical matter, most of our clients have fewer than five employees.

I am pleased to be here this morning to offer our observations on a subject we believe to be very important to small business. It is this belief that prompted us to agree to amass information and report out on it when asked only last week to do so. In this regard, we immediately sent a request to our offices to provide us input relative to their clients' experiences in seeking and obtaining loans and credit lines.

Consequently, the information we have is only a few days old. While not fleshed out in detail, we hope it will give you a snapshot of the experiences of owners of small businesses in an area so important to their fulfilling the American dream.

There are some givens in the equation we are considering, and I think some of them have been alluded to by Dr. Ferguson. Small business is critical to the viability of the nation's economy. Another is that almost all small businesses need financing. Further, most of the loans small business owners are looking for do not involve huge amounts of money. The loan range being sought normally is $250,000 or less. In most instances, the amounts are under $100,000. In many of those instances, there are substantially less than even that amount.

Our findings show that access to capital has not gotten easier or even has remained the same. Gone are the days when a small business owner need only show a bank that he or she is a good person with a good idea. Other factors now must be added, among which are that the person seeking assistance must have a strong financial background, and there is a need to furnish compelling support demonstrating that the good idea will work. Both require staggering paperwork. After all that, applications for financing often are turned down.

Our information reflects that many entrepreneurs who do not have the strong financial backing to which I just referred are asked to offer their homes and other personal assets. Further, if a lender is willing to make a loan to small business for expansion, the demands made by the lender may be extremely high.

While there is obvious recognition that a lender has a vested interest in some comfort level in believing an idea will work, our responders feel that the demands they are facing are unrealistic, often necessitating other avenues to start or expand a business.

To illustrate, why should a small business owner be able to receive immediate financing for a truck being purchased for the owner's business and not qualify for a business expansion loan for the same amount as the truck loan because assurance of the success of the expansion cannot be demonstrated to the satisfaction of the bank?

Why should small business owners find it more realistic to lease equipment rather than to endure the anxiety and often futility of trying to obtain a loan to purchase it? Yet these are the experiences our clients have shared with us.

Of note is that our responders in the main have observed that small business owners are being driven away from the national banks, particularly the large ones. This is because of the difficulty in obtaining financing and the bureaucratic business methods of those banks.

The almost unanimous finding is that the small business owners Padgett Offices serve prefer local banks for their financing needs.

Finally, it should be observed, and we have already heard it this morning, that interest on loans does not seem to be a factor. Padgett's clients often extend the credit lines on their credit cards in order to finance expansion of their businesses or to have the financing needed to get their businesses off the ground.

Thank you for this opportunity to testify this morning. As always, Padgett Business Services and the Padgett Foundation will be pleased to work with you in any capacity you believe will be helpful, and of course, I stand ready to try to answer any questions you may have of me.

[Mr. Shapiro's statement may be found in appendix.]

Chairman MANZULLO. Thank you very much, Mr. Shapiro. Appreciate your testimony. I will be asking a question of you and Dr. Dunkelberg as to whether or not the surveys that each of you took are surveying the same types of business people because you came up with two different conclusions on them.

Our next witness is Arthur Johnson, speaking on behalf of the American Bankers Association, and we welcome you here today. Mr. Johnson.

STATEMENT OF ARTHUR C. JOHNSON, CHAIRMAN AND CEO, UNITED BANK OF MICHIGAN

Mr. JOHNSON. Thank you, Mr. Chairman, and thank you for holding this hearing.

Meeting the needs of our small business customers is vital to the health of our local economies and the success of our banks. We understand the importance of bank financing to these firms and the jobs they created.

United Bank, like banks across the country, has built its reputation on meeting the needs of our customers, not just for today but for a lifetime. We cannot ignore, however, the fact that the economy has shifted into lower gear. Any experienced driver knows to slow down when the road gets rough. The same is true of bank lending as economic conditions get bumpy.

In my testimony today, I would like to make three points:

First, small business lending is a core part of banking's business. Small businesses make up three-quarters of all business banking customers. At United Bank 99 percent of our business lending is to small businesses, and 35 percent of those are SBA loans. Today, banks have more than $230 billion in loans outstanding to small businesses, almost a 10 percent increase from the last year's level, and we continue to meet the needs of small businesses.

Second, while small business lending continues to grow, economic conditions suggest caution. The local economy that my bank serves is highly dependent upon manufacturing. Having been in business for over a century, we know that economic downturns hit us sooner and harder and will last longer than other regions of the country. Therefore, we must watch for early signs that the winds have changed.

But let me be very clear. We are in the business of lending and that is what we intend to do. Good creditworthy borrowers will always have access to funding and we are always mindful of our role in helping our economy return to sustainable growth.

However, the risks of lending today are certainly greater than they were a year or two ago. We are looking more carefully at our loans and asking our customers more questions about their business plans and whether those plans accurately reflect the slowdown in economic activity. Not surprisingly, business loan demand nationally has slowed too. Such conservative approaches to both borrowing and lending are prudent in the face of uncertain economic times.

My third point addresses how congressional action can help small businesses access to credit. Certainly you deserve great praise for the merchant banking provisions and the expanded collateral provisions for Federal Home Loan Bank advances enacted in the Gramm-Leach-Bliley Act last Congress. If properly implemented by regulators, this will provide needed credit and capital for small businesses.

Protecting the SBA guaranteed loan program is also important as it can be one of the most cost-effective, high-impact tools that Congress can provide. The guarantee helps banks protect against losses and provides credit that would be otherwise unavailable. For small businesses the assistance can be the difference between survival and failure.

My bank specialized in SBA lending, but have scaled back because of the rising fees in this program recently. The recent budget proposals which would once again raise fees for borrowers and lenders, are likely to spoil this product altogether, making what is now a marginal business completely uneconomical. This may reduce the credit available for these small business borrowers as they seek access to funds in a slowing economy.

There are also tax incentives that would be helpful. Repealing the estate tax will help the inner-generational transfer of small businesses, establishing special farm deposit accounts to help smooth income for tax purposes would provide a new risk management tool for farmers and ranchers. Expanding industrial revenue bonds, called AGI bonds, for agricultural borrowers would help. And expanding the Subchapter S law would provide small businesses a broader range of capital funding options.

Mr. Chairman, small businesses are vital to a strong economy. We are always looking to meet the needs of creditworthy borrowers, even though we must be cognizant of the changes in economic activity.

Thank you for this opportunity.

[Mr. Johnson's statement may be found in appendix.]

Chairman MANZULLO. Well, thank you for that excellent testimony.

Our next witness is Douglass Tatum, as CEO of Tatum CFO Partners. It is a partnership of career financial officers serving early-stage companies, middle market companies and large corporations. The firm began in Atlanta; has expanded on a national basis, and has over 300 partners in 23 cities. He is a recognized expert on financing companies in transition and is a frequent speaker presenting Tatum's CFO booklet “No Man's Land Where Growing Companies Fail.”

You know, I like the names of these books and publications. They are so candid, to the point.

Mr. Tatum, I look forward to your testimony.

STATEMENT OF DOUGLASS M. TATUM, PARTNER AND CEO, TATUM CFO PARTNERS, LLP

Mr. TATUM. Thank you, Mr. Chairman.

I do not think it is an understatement to quote from your letter inviting me to testify before this Committee that "it is imperative for our Nation's economy small and mid-sized businesses access the capital necessary for growth and survival."

I would like to make one very, very important differentiation—the difference between a "small business" and a business that is breaking out and growing.

The National Commission on Entrepreneurship recently conducted focus groups with over 250 CEOs of these growing businesses across the country. In its report, entitled "Building Companies, Building Communities," the Commission concluded that the lack of available capital at a reasonable cost is a critical problem facing entrepreneurs.

The recent U.S. economic expansion has been a period of substantial growth in employment. I think we all realize that. According to the recent studies by the Kauffman Center for Entrepreneurial Leadership and Cognetics, the greatest growth in employment has come from these emerging growth entrepreneurial businesses. If you do a survey of 100 small businesses, only five of those businesses are growing at 15 percent or more. So, in a survey asking about capital and its importance, five of those businesses—less than five percent—are going to raise their hands and say, "It's extraordinarily important." Those are the businesses that I want to talk about.

Now, why is that important? For example. Cognetics data indicates that 84 percent of the net, new job growth from 1992 through 1996 were these rapidly growing firms.

My testimony on these matters before the committee comes from the perspective of serving as CEO, as you mentioned, of the largest CFO firm in the country. We have partners in 23 offices, and we provide assistance for a variety of companies in all the spectrums ranging from start-up to Fortune 2000 multinationals. In our role as CFOs, we are responsible for purchasing tens of millions of dollars worth of capital, and we purchase it from both regulated, non-regulated and professional private equity investors such as venture capitalists.

In addressing the issues surrounding the lack of capital from our perspective, it is important to summarize the microeconomics of the borrower first and then the lender.

We would suggest based on our firm's collective experience that the bulk of the capital gap problems experienced by entrepreneurial CEOs coincides with his or her company's sudden growth accompanied by a transition period during which the company becomes "too big to be small and too small to be big." We refer to this economic transition period as "No Man's Land."

During this period of growth, the company is extremely fragile and can quickly lose its economic momentum due to a lack of management, human resources, infrastructure, and to the point of this committee, reasonably priced capital. We have provided the Committee with the firm's booklet "No Man's Land"; hopefully, it will give you some perspective on my testimony.

The problem with these companies—again I want to remind us that only five percent of small businesses are growing at 15 percent or more a year growth—the problem for these companies starts with growth. Growth in revenue drives growth in assets, creating demand for capital and perpetually cash-starved borrowers even with significant profitability.

If you will take a look at the first chart that I have in my written statement labeled "Micro–Economics of 15% Sales Growth," that's a model of a company starting with about $2.8 million growing at 15 percent a year. What you see there is that profits are going up, while cumulative cash flow is increasing negative. These companies are generally thinly capitalized to begin with, and as indicated above, generally are in a risky transition.

As indicated in our booklet, "No Man's Land," the key to raising capital for these businesses is creating a reduction of risk for the borrower.

The second chart in the written statement indicates that as the risk of the business is lowered the access and the pricing of the capital improves.

The Lenders: Providers of capital to these emerging growth companies address the risk problem through intense account and collateral management. In preparation for this testimony, we polled several of our partners and other senior industry executives with extensive experience in both the regulated and nonregulated financial markets. Part of our review included a confidential evaluation of the economic pricing and microeconomic models of these types of lenders. In summary, both regulated and nonregulated institutions provided data indicating that the actual cost of collateral management, account management, and loan acquisition and origination for loans below a million dollars can be upwards of 1400 basis point, or 14 percent. These fixed costs, when added to the normal risk-adjusted interest rates, create an overall cost to the borrower that becomes the real issue. The costs associated with this risk management becomes less significant with the increased size of the loan, creating a funding gap of reasonably priced capital between what a company typically raises at start-up from banks, government programs, savings, credit cards of up to about $250,000, and what we estimate to be the level of $1 million that becomes economically viable from both the borrower's and lender's perspective.

To depart from my written statement for a moment, what we are seeing is that the initial capital funding is provided primarily on the assets of the individual. I would call that a "branch manager loan." When you get above $250,000 in capital needs and the companies are growing and looking for capital, what happens is that the bank is forced to look at the business's assets at that point. That becomes a "commercial loan officer's loan". So, with the capital gap between $250,000 and $1 million, it would not surprise me that there is not a problem out there getting the initial capital funding. It is between $250,000 and $1 million where we are finding the real problem; and interestingly enough, those companies are the ones generating the job growth.

I would suggest to you that when your constituents come up and complain that they can not find capital, you will find them as growing companies versus stable, small companies that are not growing at a significant rate. The ones accessing capital above $250,000 are who you are really talking to.

There is no doubt that some of these financing needs are being met by a variety of sources, including the SBA, the SBIC programs, banks and other nonregulated lenders who I absolutely believe are highly interested in solving this problem. However, we would argue that until a more cost-effective risk management process is developed, many of the regulated institutions will continue to use a rules-based credit scoring as part of their underwriting procedures for rapidly growing companies, effectively eliminating many of these companies from consideration. In addition, the general trend will be to target this type of growth capital to larger business customers and larger loans where the costs outlined above are not as significant to the overall pricing.

Finally, there is one other item that we believe should be brought to your attention. In our firm's opinion, current tax policy compounds the difficulty in retaining critical capital for a company during the formative growth phase because it requires an expanding business to pay a tax at a time when it may be cash flow negative and unable for the reasons outlined above to obtain reasonably priced capital from lending institutions to fund its continued sales and growth.

Congressman DeMint and Congressman Baird and their staffs and others have been very helpful in working with our firm to develop and refine a tax deferral proposal for emerging growth businesses designed to address this problem, and we would hope that this committee would give it appropriate consideration at the time when the proposal is introduced as a bill.

There's one other point I would like to add—an excerpt from the NFIB "Small Business Policy Guide" on the highest priorities for small business—and I quote, "Cash, cash, cash, the first canon is cash. Cash flow is everything in small business. Owners need money. Cash impacts are particularly notable when businesses are growing very rapidly. Without cash, not to be confused with illiquid assets, business owners must either postpone investment and expansion or they must borrow, thereby incurring financing costs precisely when these costs are least needed. And tax policy, to the extent practicable, should alleviate small business cash problems, not exacerbate them."

In conclusion, Mr. Chairman, I really appreciate the opportunity to appear before your Committee. I will be glad to attempt to answer any questions the Committee may have regarding the capital needs and financing issues facing growing businesses.

[Mr. Tatum's statement may be found in appendix.]

Chairman MANZULLO. Thank you, Mr. Tatum.

I would like to conclude this meeting at 12:15, so we have got about 15 or 16 minutes. And if we could limit the questions to maybe four minutes, then maybe have a second round so everybody gets in.

Mr. Akin.

Mr. AKIN. Thank you, Mr. Chairman.

Doug, I was interested in a couple of things. Let me see if I got what you are saying. When you are water skiing you go from two skis to one ski, there is a little instability period. You are saying there is a financial instability when you are moving from about 250,000 into the million kind of range. That is where there is a need, and this need is not in every small business, but it is in five percent of them which really have the potential for very rapid growth, and the rapid growth is the very thing that makes them cash poor.

Have I got this right so far?

Mr. TATUM. Excellent, excellent summary of that.

Mr. AKIN. That was a wind-up, now I have got a question or two.

The question, first of all, is in that area, first of all, how are the private side from the federal government—I am new on the committee so some of this may be obvious to some of the other members, but how are the privates providing for that need and what do you see, aside from some potential tweaking of the tax code, that we ought to be doing to meet that need?

Are we doing a good job in helping in that area or not? And is it sufficient to let the privates cover a lot of that?

Mr. TATUM. To answer your question, I think that the privates are intensely trying to figure out how to deal with that. In my discussions with a senior loan executive at a community bank yesterday, probably a billion dollar bank, the portfolio that he has in this range is only about $6 million. What they are looking at is ways of cross-selling enough services to those borrowers in order to make those issues profitable.

In conversations with a large nonregulated lender——

Mr. AKIN. I did not follow your—what is the problem of the bank with the billion dollars trying to get into that market? What is his mechanical problem?

Mr. TATUM. The mechanical problem is the intensity of the collateral management needed and who they need to assign to that account. You need an experienced loan officer. You need collateral management on the business itself. You have now gone past what the personal assets of the individual can support.

Mr. AKIN. Okay.

Mr. TATUM. When you look at the cost of actually having the right kind of person monitoring that loan, and the collateral management that needs to be provided for that loan, it is very difficult to make any money on that loan without charging interest rates that exceed 20 percent, and that is the difficulty that they are facing in that gap.

Now, you get to $1 million loan, and those fixed costs become less and less a part of that amount. What we find anecdotally as chief financial officers is if we can get a business big enough to where it can borrow $1 million on its own assets, the private sector—both commercial banks and nonregulated lenders—will line up to provide financing. It is that difficult between the capital that is being lent to him early and the transition from the two skis to the one ski, and it is the cost of the collateral management and account management is the problem.

Mr. AKIN. So I understand what you are saying, your overhead in trying to make sure that it is a good loan eats up all of your profit. You do not have time to go out an micro-management some little operation and make sure they are doing everything right?

Mr. TATUM. It costs as much to do that for, let us say, a $400,000 or $500,000 loan as it does $1 million loan or a $2 million loan, and I think that is the practical problem.

I do not think it is a regulatory issue. I think there is a recognition that there is a need to get capital there, but the reality is that these are risky businesses and they require intense collateral management.

Mr. AKIN. Thank you.

Chairman MANZULLO. Thank you very much.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Johnson, yesterday we held a hearing on the SBA budget, and we were—I was raising the issue of the imposing fee to the SBA 7(a) loan program. And you touched on this point in your testimony, but I would like for you to expand a little more.

In the President's budget, he proposes to increase borrower and lender fees on the 7(a) loans over $150,000. And the stated intent behind the fee increase is to encourage smaller loans to go right through the program.

Do you think that this fee increase would cause 7(a) lenders to make more loans under $150,000, to make more loans?

Mr. JOHNSON. Well, it is certainly possible that it may have the desired, stated desired impact of increasing lending in the smaller loan arena. But it would also have the impact of decreasing lending activity to the larger businesses. And very often we find that, as I think I mentioned briefly in my testimony, our bank used to be a very active SBA lender. In fact, through the mid eighties, for nine years through the mid eighties to the mid nineties our little bank was the leading originator of SBA 7(a) loans in the State of Michigan.

We have since de-emphasized our SBA 7(a) lending activity somewhat, largely because rising fees to both our borrowers and ourselves have made the program less economically viable.

We are in a state where we are in manufacturing. We have a large amount of lending activity to small businesses who are manufacturers, and those are capital-intensive businesses. So our loans, our SBA loan history tends to be—even for new businesses—larger dollar amounts because they need to buy industrial equipment and a factory to put the equipment in.

And so the damage that could be done to those borrowers would be very detrimental.

Ms. VELAZQUEZ. Mr. Johnson, if this fee changes go through, would you still participate?

Mr. JOHNSON. Well, yes, we would, but it would be much de-emphasized.

Ms. VELAZQUEZ. Can you tell me what are some of the major factors that cause a credit officer to consider a commercial loan to be high risk?

Mr. JOHNSON. Well, it can vary greatly, depending upon the industry that the business is in. But what it basically comes down to are a couple of factors.

First is what in our judgment is the probability that the loan will be serviced as agreed. In other words, that the money will be repaid to us in a timely fashion. And second of all, in the event that there is a default what is the likelihood of our ability to be able to recover the amount of the loan back, even if we have to sell the collateral and liquidate the business.

Ms. VELAZQUEZ. Thank you, Mr. Johnson.

Mr. Shapiro, in your firm's experience are small businesses that are being rejected by traditional private lenders seeking assistance through SBA's loan programs are they seeking other avenues to obtain credit?

Mr. SHAPIRO. Some of them are in fact seeking loans from the SBA and like organizations. Our assignment was with respect to nongovernment lending institutions. I think they are having not as difficult a time from SBA in seeking financial assistance.

Ms. VELAZQUEZ. Do you refer businesses to SBA loan programs?

Mr. SHAPIRO. Our office owners in fact do. Wherever money may be available is where we refer them.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Congresswoman Tubbs Jones.

Mrs. TUBBS JONES. Thank you. I am going to be brief because I know the time is of the essence. Good morning, gentlemen. Thank you for coming to present. I hail from the City of Cleveland, and working very hard to empower or do economic empowerment for my community.

I would like to raise the question specifically with regard to minority businesses. If small businesses are having the dilemmas that you suggest, have you done any assessment on the impact on small African–American businesses? Do you have suggestions of different changes we could make? Would you be willing to join with us in sending a letter to President Bush about the impact that the cuts that the SBA has had, cut on SBA has had on your ability to do your job as part of the Small Business Administration? Your organization or whatever, anybody can take a jump at this.

Mr. Tatum? Mr. Johnson? Mr. Tatum?

Mr. JOHNSON. I guess it is my observation that in a period of economic downturn those businesses that are most likely to have problems obtaining credit are those businesses that are either less mature, they are newer, or those that have a smaller capital cushion, less equity, and there tends to be quite a bit of cross-over there. I mean, there is a high correlation between the amount of capital they build up through profitable operations over the years, and the age of the business.

So while I do not think that there is a problem for minority-owned businesses because they are minority-owned business, I can see because there has been such a dramatic rise in minority-owned business formation over the last several years that a large number of minority-owned businesses would fall into that immature category that may experience more difficulty in.

Mrs. TUBBS JONES. But the Federal Reserve did in fact do a study that said that the lending to minority businesses, lending to minority persons, first of all, and then to minority businesses was not equitable over the last few years. I do not remember exactly when that report came out. I remember Mr. Greenspan speaking to that.

So if that is the case, along with the situation, economic situation we find ourselves in, does that mean economic—I mean, minority businesses are taking double whacks to the extent that the economy is not in great shape. Would you agree or disagree?

Mr. JOHNSON. Well, it would be my observation that the bankers that I am—in my bank——

Mrs. TUBBS JONES. Representing the bankers.

Mr. JOHNSON [continuing]. And the bankers that I am representing are interested in making loans to any and all creditworthy persons.

Mrs. TUBBS JONES. I am not questioning—please be clear, I am not questioning whether or not you lent—well, maybe I should. How many of your loans are—do you make to minority businesses?

Mr. JOHNSON. Well, I do not have the percentages, but it is certainly a business sector that we are very interested in serving.

Mrs. TUBBS JONES. Okay, I do not mean to cut you off but I am short on time.

Mr. Tatum, in the work that you do, do you do work with minority businesses? And what has been your experience, if any different from what you have testified to already? And real quick add on, did the new markets initiative proposals brighten your eyes about opportunity to provide support to businesses, disadvantaged businesses?

Mr. TATUM. I believe that the capital markets are color blind, and that they will seek those businesses that represent returns for them very efficiently.

It is interesting, in my opinion, and this is anecdotal so I do not have any kind of research to support this, but I think business start-ups is a cultural thing. That is something that we should encourage. The minority community is increasing its participation, which is extraordinarily healthy.

Chairman MANZULLO. Let me cut you off there. I am going to let Congressman Baird get a question before we have to go vote.

Mr. TATUM. I apologize.

Mr. BAIRD. Mr. Chairman, thank you, Ranking Member Velazquez.

I want to particularly compliment the panelists and the Chair and Ranking Member for this. Mr. Tatum, I appreciate you acknowledging the work you have done, along with Congressmen DeMint and I.

It is my belief from talking to a number of small businesses that while we have done a lot to help businesses get started through the SBA program, rapidly growing businesses who sort of got their feet under them, had the first two or three survive that critical cutoff point, I really believe that is where the greatest small business employment currently resides.

The first year you are there you are with your wife, your kids, your next door neighbor, your credit cards. It is after you have survived that three years, that is when you start employing people, that is when you grow. And the bill we are working on, Mr. DeMint and I, and I hope this committee can have a hearing on it, could you expand on that issue, that sector a little bit, and how we might help those folks?

Mr. TATUM. We believe that this is the most important issue to look at because the research that we are reviewing from the Kauffman Foundation and others indicates that those businesses are generating the majority of job growth. Those businesses are perpetually cash starved by virtue of growth, and the capital markets are struggling with how—because of the risk—to cost effectively get capital into those businesses.

We would argue that allowing those businesses to preserve capital is a timing issue. We think the proposal is revenue-neutral over time, and allowing those businesses to preserve capital has huge consequences to the economy.

Right now, even under current conditions, there are emerging growth businesses that are growing. They are the only businesses that are adding employees in a downturn. I have been a CFO of larger organizations. Those larger businesses tend to adjust their economic models quickly by downsizing. The emerging growth businesses are adding employees, and they are extraordinarily cash starved. Some of the tax issues that you have been working on would, I believe, help to solve that capital funding problem.

Mr. BAIRD. So, in other words, some of our SBA programs currently focus on an area where we have the highest risk maybe of lack of success, but the sector where we have got the most rapid growth is the area precisely where we have the least access to capital.

Mr. TATUM. Absolutely, and it has the most economic impact on the economy.

Mr. BAIRD. Excellent. Thank you, Mr. Chairman.

Chairman MANZULLO. Well, thank you.

I wanted to comment on the survey. Mr. Shapiro, your survey was done among—how many businesses participated in that?

Mr. SHAPIRO. There were approximately 1500. I think the purpose of our discussion. we are probably not that far apart, and that was the point you made earlier.

Chairman MANZULLO. For those of you, could you—Doctor, you said that there was no credit crunch among your participants, but Mr. Shapiro, you said there was? Could you resolve that?

Mr. DUNKELBERG. Well, I am not sure we can resolve it sitting here.

Chairman MANZULLO. Is it different sized businesses or what is it?

Mr. DUNKELBERG. NFIB has about 500 to 600 thousand member forms. I do not keep track of it——

Chairman MANZULLO. The average employee is at three?

Mr. DUNKELBERG. The average employment of those firms, the average employment is about 13 or 14.

Chairman MANZULLO. Oh, I see.

Mr. DUNKELBERG. Ninety percent are under 40 employees, and so it's very small, though somewhat larger than what Census says is out there, but it is a very, very large——

Chairman MANZULLO. Okay.

Mr. DUNKELBERG [continuing]. Body of firms, and probably misses the very, very small firms. And the distribution by industry, construction, manufacturing, agricultural and so on, it is pretty much the same as Census says is out there.

So it is a pretty representative group in that sense.

Chairman MANZULLO. As is your group, is that correct, Shapiro?

Mr. SHAPIRO. Yes, it is.

Chairman MANZULLO. Okay.

Mr. SHAPIRO. But let me point out that I do not know when the NFIB survey was conducted. Ours was conducted last week.

Mr. DUNKELBERG. Ours is every month.

Mr. SHAPIRO. Well, I do not know which ones you are using for your analysis, though.

Chairman MANZULLO. Are you agreeing or disagreeing?

Mr. SHAPIRO. Well, I think we are not that far apart. We were told to obtain stories, and we had to extrapolate from those stories the information in——

Chairman MANZULLO. Okay.

Mr. SHAPIRO [continuing]. Our conclusions. And normally the people who respond in that setting will give us the negative stories, not the happy stories.

Chairman MANZULLO. Yes.

Mr. SHAPIRO. So we did not conclude that it was getting worse.

Chairman MANZULLO. Yes.

Mr. SHAPIRO. Although there could be an indication, we tried to be very careful in our written statement.

Chairman MANZULLO. That is about your conclusion too, is it not, Dr. Dunkelberg?

Mr. DUNKELBERG. It is not getting worse, that is correct.

Chairman MANZULLO. Okay.

Mr. SHAPIRO. It has not gotten better, but we are not sure that it is gotten worse. It is hard to draw a line in the sand as to when it may have started getting worse, you know, two years ago, one year ago, a month ago, we are not sure.

Chairman MANZULLO. Let me throw something out here and then we are going to have to adjourn. One of the witnesses that we had or scheduled was Sunil Puri from Rockford, Illinois. He is unfortunately in the hospital. I had calls with him a couple of months ago and he is a professional developer, so he would have to get capital to develop his shopping centers. Then the people who would occupy those shopping centers, those stores, would have to get capital.

He said the train has been cut off. It has been going on for six months now. It has been very difficult for him to get development capital, and he is very substantial, very successful, a lot of assets. And the retail stores that would open up, they have also been cut off.

Mr. DUNKELBERG. I think if you look at the mid-market kinds of borrowers, and of course the Fed survey of the 52 largest banks——

Chairman MANZULLO. Right.

Mr. DUNKELBERG [continuing]. Tells you that there has been a restriction in credit availability for big projects which really depend on the health of the economy to borrow a lot of funding.

Chairman MANZULLO. I do not know how big a project is when you are trying to——

Mr. DUNKELBERG. Pretty big on shopping center.

Chairman MANZULLO. Well, shopping, that is the big loan.

Mr. DUNKELBERG. Yes.

Chairman MANZULLO. But then even the little guys that would open up the individual stores, they cannot get loans themselves. And his testimony would have been, you know, to that effect from the developing side, and also to the people who would open up those retail stores that has been a severe crunch of credit.

Mr. DUNKELBERG. I would also suggest that, of course, the economic activity regionally has high variance, and right now I think most of us would agree that those states in the middle of the country called the Midwest are "in a recession" because of their heavy dependence on manufacturing, but that is not the case all over the country, and we are looking at numbers, of course, that characterize the whole country.

Chairman MANZULLO. That could be, and we do not have time perhaps—we have another hearing, there is a whole genre of community or mutual banks throughout the country that they cater to the little guy because their clientele essentially is the little person, and they—I do not want to say of a different mission, but they do tend to gravitate towards the small towns, to embrace the small businesses. They still believe at times in character security, and sometimes character security is better than security on a new truck, as far as I am concerned. But I am not the one that does the underwriting on it.

So, you know, we have a real flow that is going on right here, and I just want to again thank you for your participation and for the excellent testimony.

Mrs. TUBBS JONES. Mr. Chairman, even though we are almost done, can I get him to finish his answer to that last question I was asking for the record? I mean, you can go ahead, I can hear it. All I want is on the record to end the questioning. He was talking about that the minority community, that lending, that capital lending is culturally, and I wanted to hear the end of that.

Mr. TATUM. The entrepreneurs are rewarded and not penalized for trying to start businesses in this country. It is a cultural thing. The minority community has just started to participate in that. That is anecdotal. I do not have the research for that.

Mrs. TUBBS JONES. What do you mean it is a cultural thing?

Mr. TATUM. In other words, in some cultures if you start a business and fail, you are ostracized. In this country you can start a business and fail, and try again and fail, and try again and get it right by the third time. You get a second and third chance. So that I think business start-ups happen because we culturally admire people who take those chances.

Out of that—out of that cultural start-up comes a group of small businesses that shoot out of that.

Mrs. TUBBS JONES. Okay.

Mr. TATUM. Those businesses are the ones that start generating all the jobs growth. They have a different set of needs. And out of those group becomes those ones that the venture capitalists are interested in, the IPO markets. And so what you want to be able to do is have the minority population participate in through all that, and they are just getting started in the bottom layer.

Mrs. TUBBS JONES. Thank you. Thank you.
Mr. TATUM. If that makes sense.
[Whereupon, at 12:20 p.m., the committee was adjourned.]

House Committee on Small Business

"Access to Capital"

May 17, 2001

Opening Statement of Committee Chairman Don Manzullo

Good morning. The hearing will now come to order. On behalf of the Members here today and myself, I welcome our witnesses and thank you for your participation in this hearing.

Capital is the lifeblood of small businesses. For a citizen with the dream of becoming an entrepreneur, a small business owner looking to more efficiently bring goods and services to the marketplace, or a small or mid-sized business attempting to maintain profitability, access to capital is imperative for growth - and in many cases - survival.

Our hearing today will focus on private commercial lending. Yesterday, the Committee met to review the proposed budget for the Small Business Administration guaranteed lending and assistance programs. Before small businesses rely on these programs for capital assistance, they must attempt to access investment from private lending channels.

Clearly, our Committee must be cognizant of private commercial lending in order to determine the demand for SBA lending and assistance. Recently published data suggests it is more difficult for entrepreneurs to attain private lending. Last March, the Federal Reserve's results from an impromptu U.S. bank survey supported evidence of tighter loan standards for businesses attempting to obtain commercial and industrial capital. While stricter standards do not necessarily mean credit is unavailable, the data suggests that firms once barely qualifying for a bank loan will now seek other sources, such as a SBA guaranteed loan.

The Committee will also investigate how federal and private policies affect non-governmental lending; whether small businesses are accessing necessary credit and capital through the private lending sector in the recent slowing economy; and related access to capital issues affecting our Nation's small businesses.

Hopefully, this informative hearing will lay the groundwork for future hearings in the 107th Congress. I commend my good friends and Subcommittee Chairs Mr. DeMint and Mr. Toomey for their work in this area, and for their anticipated joint Subcommittee hearing on legislation Mr. DeMint and Mr. Baird are developing to bridge the gap medium-sized businesses face in accessing capital investment. Doug Tatum from Tatum CFO Partners will join us on our second panel today to explore the parameters of this serious problem.

It is my distinct privilege now to also recognize the Member of our first panel, Federal Reserve Vice-Chairman Roger W. Ferguson, Jr. Dr. Ferguson took office October 5, 1999, as Vice Chairman of the Board of Governors of the Federal Reserve System for a four-year term ending October 5, 2003. I will elaborate further on his distinguished record before he testifies, but first I will recognize my friend, the Ranking Member from New York, for any statement she may wish to make.

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
107th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-0315

Congresswoman Nydia Velázquez
Statement before House Committee on Small Business
Access to Capital Hearing

Thank you Mr. Chairman.

Access to capital is one of the most critical components to business success. A business that can obtain funding quickly and at a reasonable cost has a much greater chance of succeeding. Unfortunately, for many small businesses, getting access to cash flow is not always that easy. One only needs to look at the fact that the vast majority of business start-ups are done not by conventional loans, but by credit cards to realize this. Yes, credit cards are readily accessible, but they are high cost and hold the potential to quickly saddle a business with a stifling amount of debt.

Make no mistake, lending for business start-up and expansion is very much a high-risk -- high reward venture. I believe that many of our financial institutions are looking for innovative ways to assist small businesses to obtain the funds they need to start and grow their business. Unfortunately, banks can not do it alone. Not only do they operate at a time when federal regulators prod banks to tighten loan underwriting criteria - - - they must also operate in a new era created under Graham-Leach-Bliley that has spawned a very competitive environment for the deposit that make it possible for lenders to make loans.

Today, with so many different competing interests vying for those increasingly scarce funds, it is no wonder both lenders and borrowers are frustrated. This is where the SBA loan programs come into play, with their ability to guarantee funds that allow banks to set aside less of their scarce deposits and maximize their lending potential. By doing this, we increase the ability of our financial institution to offer loan opportunities for small businesses. This partnership has been so successful that currently SBA loan programs account for 40% of all long term small business loans nationwide. It is because of this relationship that you can not talk about access in the private lenders market without considering it within the context of SBA's loan programs.

That's why the proposal by the Bush administration to increase fees is not only harmful to our small business owners, but it is harmful to our lending system. Time and time again when fees on these programs have been increased, the ability for banks to offer loans has plumeted. At a time when our economy is creating more questions than it is answers, we need a strong and well functioning guarantee loan system to ensure that our small businesses have access to the capital they need to survive.

In closing, it is clear that access to capital for small business is truly access to opportunity, which is why this committee has spent so much time working to ensure that our nation's small businesses can access the funds they need to start and grow their businesses. I want to thank the witness for coming here today and I look forward to hearing their testimony.

For Release on Delivery
10:00 a.m., EDT
May 17, 2001

Statement of

Roger W. Ferguson, Jr.

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Small Business Committee

United States House of Representatives

May 17, 2001

I am pleased to appear before this Committee to discuss the availability of credit to small businesses. Before turning to the latest information on credit market conditions, however, I think it important to highlight the special characteristics of small businesses that make them such an important part of our economy and at the same time create a heterogeneous set of financial needs and credit demands. Much of the information that we have on small business financing comes from surveys, including the Federal Reserve's Survey of Small Business Finance, the latest of which was completed last year.

Importance of Small Businesses

No doubt I am preaching to the choir when I tell this group how important small businesses are in our nation's economy. The statistics collected by the Census and Small Business Administration are indeed remarkable. These data reveal that there were more than 24 million nonfarm business tax returns filed in the United States in 1999. More than 99 percent of these returns were for small businesses, that is, firms with fewer than 500 employees. Roughly half of these were self-employed persons and about a third were part-time. Based on SBA estimates, small businesses employ more than half of the private work force and are responsible for around 50 percent of all sales and private gross domestic product, a share of output that has remained fairly stable over time.

With half of our nation's private, nonfarm output coming from small businesses, obviously our economic well-being depends greatly on this sector. But small businesses do more for us than can be captured in these statistics. Small businesses are a source of new ideas and products. The list of innovations developed by these enterprises in fields such as software, computer technology, aerospace, and pharmaceuticals is quite impressive. The possibility that an idea or new product will eventually transform a small business into a large corporation is a great motivator of change and risk taking. Beyond that, small enterprises make a huge contribution in the form of the support and synergies they provide operating side by side with large businesses. They provide services and inputs to the production process, train workers, and are a primary means of marketing and distributing retail products and services.

An essential feature of a thriving small business sector is the ability of firms to start up, to grow, and to change ownership. Just as essential to the dynamism of our economy is the ability of these firms to downsize when that improves profitability or to exit the markets when their resources are more highly valued elsewhere. There is a tremendous amount of turnover of small firms. In 1999, approximately half a million firms (excluding self-employed for which numbers are not available) closed for one reason or another--perhaps they merged or were acquired by a larger firm, perhaps they failed, or the owner found other reasons to move on. At the same time, more than half a million new businesses were created.

The continuous entry and exit of firms is a clear sign that resources are responding to shifting demands of consumers and businesses and to changes in the costs of production.

The flow of labor and capital from less productive to more productive uses is the cornerstone of a dynamic and healthy economy. A downside of this churning is the greater uncertainty that attaches to the earnings and risk profile of each individual small business.

This has significant implications for the financing of small businesses. Indeed, while a number of factors need to be in place for a small business sector to thrive, including a mobile labor force and a sound infrastructure of laws and regulations, perhaps the most important ingredient is access to capital and credit.

The Financing of Small Businesses

The financing needs of small businesses are as varied as the population itself. The life cycle of a small business can take many forms, with very different implications for the types of risks and returns that lenders and investors can expect. For new ventures that have high risk profiles and high expected returns--as do many start-up firms in the tech sector--the initial stages require commitments of equity capital, sometimes from family and friends and sometimes in the form of venture or private equity capital. Further injections of equity are required in the early stages of growth and ultimately some form of "take-out" financing is arranged, such as an initial public offering or a buyout by another firm, that allows the venture capitalist to extract his or her investment.

The past decade has been impressive for the large amount of equity capital that flowed to venture and high-tech enterprises in this country. The National Venture Capital

Association estimates that investments in emerging enterprises totaled $214 billion over the past five years, and exceeded $100 billion last year alone. The number of companies funded last year was a record 5,300. About 270 companies that originally were backed by venture capital were purchased by other companies last year. Another 250 were able to go public through initial public offerings (IPOs) of stock, even as the market for publicly traded equity was in the initial stages of its recent decline. The average age of firms going public was about seven years, but many were older, which is indicative of the potentially long-term commitment that investors in venture enterprises must be prepared to make. It is safe to say that the United States has been a role model for countries in Europe and Asia seeking to develop markets for equity financing for small businesses.

But for every new, high-growth firm seeking venture capital, there are hundreds of small businesses in the manufacturing, construction, trade, and service sectors that have quite different financing needs. Some of these firms have established operating histories and marketable assets that make them good candidates for credit from conventional financial institutions. A few are small corporations that have access to bond market financing, though their bonds are likely to be rated below investment grade. The vast majority are small enterprises with few assets to pledge as collateral and with only limited operating experience from which investors can assess operating performance and future earnings streams.

Recognizing the importance of small businesses, we endeavor to understand the sources and uses of credit by different sizes of firms. To this end, the Federal Reserve has undertaken three national surveys of small businesses, the first in 1987, the second in 1993, and the third completed last year. A detailed description of the latest survey, along with preliminary results, was published in the April 2001 *Federal Reserve Bulletin.* This morning I will highlight a few preliminary findings and note that the data have just become available for what promises to be interesting analytic work.

The Survey of Small Business Finances

The survey sampled 3,600 small businesses that were representative of more than 5 million nonfarm, nonfinancial enterprises that operate for profit. It gathered information on a large number of items, including each firm's use of credit; characteristics such as the number of employees, industry, and age of the firm; and its income and balance sheet data as of year-end 1998. We expect these data to be used by researchers at the Board and elsewhere to address a wide range of issues. The earlier surveys have been used, for example, to shed light on the relationship between a business and its bank or primary lender and to study how financing choice varies with location, age, size, or other characteristics of firms. The latest survey can be used to update these studies and to assess how small businesses may have altered their use of credit and financial services in response to technological and competitive changes in the financial environment.

The preliminary survey results we've glimpsed so far are interesting as much for their consistency with previous surveys as for the changes they reveal. For example, despite the large amount of structural change and consolidation in the financial service sector and the improving accessibility of capital markets to many smaller firms, commercial banks continued to be the dominant provider of financial services to small businesses in 1998. Of the 55 percent of small businesses that obtained credit from market sources or institutions, nearly three-fourths had some sort of credit arrangement, such as a line of credit, a loan, or a lease, with a commercial bank. Finance companies served about 13 percent of small business borrowers, and leasing companies served about 7 percent. The survey results also confirmed the growing use of business credit cards by small businesses. About one-third of all small businesses--and more than 50 percent of firms with 20 or more employees--had business credit cards in 1998.

We included questions on the survey about the problems small businesses considered to be most pressing. Small businesses in 1998 expressed concern about the quality, cost, and availability of labor and about increased competition from larger, international, and Internet firms. Of note, financing was not high on their list of concerns.

It is not surprising that small firms were feeling the pressures of tight labor markets and increased competition: 1998 marked the seventh year of a robust expansion. Bolstered by a technology-led acceleration in productivity, real GDP growth averaged

4-1/4 percent in the latter half of the 1990s, and the unemployment rate had dropped to 4 percent by the end of the decade. Aggregate indicators of credit availability were quite positive in the mid to late 1990s: Banks were generally easing credit terms, and business loans grew robustly at both large and small banks. The surge in equity markets provided a welcome environment for firms going public for the first time, and firms carrying below-investment-grade bond ratings were able to issue bonds at historically narrow spreads over Treasuries. While disruptions in global markets in 1998 raised risk premiums on junk bonds and bank loans and threatened a seizing up in financial markets, ultimately they did not derail the flow of credit, especially to smaller businesses.

Recent Trends in Small Business Financing

Since the 1998 survey, the economic and financial environment has again changed, and this time in ways that are less conducive to risk-taking and leverage. It became increasingly apparent over the course of last year that the pace of economic growth was slowing. Credit markets firmed, including bank lending, partly in response to concerns that a slowing economy would result in some deterioration in the financial well-being of businesses and their creditors. As corporate profits fell and businesses revised down their outlook for sales and earnings growth, investors became less certain about the returns they should expect on investments.

By late last year, equity markets looked considerably less attractive as a source of financing, especially to firms hoping to go public for the first time. The volume of IPOs dropped dramatically in the fourth quarter and remained sparse in the early months of this year, though it has not dried up entirely. As prospects for takeout financing through an IPO became problematic, private equity investors became more cautious about committing capital to earlier stages of financing. While venture capital investments exceeded $100 billion last year, the pace of investment has slowed in recent quarters and there are reports that some young firms are finding it hard to get second- and third-stage financing for venture capital projects.

In the capital markets, the default rate on high-yield bonds climbed markedly last year to its highest level since 1991, boosting lender concerns about the ability of weaker firms to service their debt in this environment. Yields on junk bonds rose appreciably relative to those on better-rated debt. In consequence, the issuance of junk bonds dropped sharply in the fourth quarter. Although the capital markets continue this year to exhibit considerable selectivity, the flow of credit through bond markets has been strong over all. Gross bond offerings by nonfinancial firms totaled nearly $160 billion in the first four months of this year. And, although they are paying higher risk premiums, non-investment-grade companies still are able to raise funds: Junk bond offerings have accounted for about 25 percent of the gross issuance this year.

As you are aware, the Federal Reserve conducts surveys of senior lending officers at large banks around the country. These surveys ask about banks' credit terms and standards, about loan demand, and other issues that may be topical. During the market turmoil in late 1998, banks began taking a harder look at the loans that they make to large and middle-market businesses. While financial markets settled down subsequent to 1998, banks appear to have maintained a more vigilant posture. Last year, in an environment of rising delinquency rates on loans and indications of declining credit quality, the net percentage of banks who reported some firming in their lending standards for large and medium borrowers rose steadily in each of our surveys.

Anecdotal reports suggest that banks were particularly concerned about concentrations of risk in sectors such as telecommunications, where returns have dropped sharply, and in manufacturing and other sectors highly dependent on energy and petroleum-based inputs. Banks also reported firming standards and terms on loans to small businesses, but to a lesser degree than for large firms. Normally, we expect small businesses to bear the first pulse of credit tightening. But the downgradings and unexpected shocks affecting large, investment-grade corporations have led creditors to rethink the relative risks of lending to large and small firms.

Banks have continued to tighten standards and terms on loans and credit lines this year. In our May survey, just over one-half of domestic banks reported tightening their standards on C&I loans to large and middle-market firms over the past three months, and 36 percent tightened standards to small firms over the same period. Most of the banks that had tightened continued to cite a more uncertain economic environment, a worsening of industry-specific problems, and a reduced tolerance for risk.

In their latest reports, bank loan officers also indicated that the demand for business credit has waned of late, largely owing to reductions in planned investments and diminished financing for mergers. Just as lenders are treading more cautiously as the economy slows, so too are borrowers. Caution is apparent even among small businesses. Importantly, the small business surveys conducted by the National Federation of Independent Business (NFIB) in the first quarter revealed that only 13 percent of their surveyed members thought the current period was a good time to expand, roughly half the percentage of a year earlier. The small businesses who thought it was a bad time to expand cited unfavorable economic prospects and a poor outlook for sales. Of note, very few--only 3 percent in the April NFIB survey--mentioned financing costs as a reason that the current period was not a good time to expand.

Indeed, the recent NFIB surveys suggest that most of the respondents have not found financing conditions to be particularly onerous to date, despite the more cautious posture of financial institutions and higher risk spreads. For creditworthy businesses, large and small, the cost of borrowing has declined with the easing in monetary policy and the associated decline in lending rates since the fall. The prime lending rate has fallen 2 percentage points since the end of last year, and the average interest rate paid by respondents on the April NFIB survey was down almost 1 percentage point over the same period, to its lowest level in nearly a year.

While we may take comfort from the lack of angst expressed by small borrowers in the NFIB surveys, I expect that many risky small businesses have found credit a bit harder or more expensive to obtain. On the other hand, there are few signs of the types of financial headwinds that prevailed in 1990 and played havoc with the ability of many creditworthy small and medium firms to renew credit lines and roll over loans. In contrast to that period, our financial institutions have had a long stretch of solid earnings growth during which to build capital and liquidity positions. In addition, although loan portfolios have recently begun to deteriorate, delinquency rates of business and real estate loans remain well below those of the earlier period. Commercial real estate markets, in particular, have not gone through the boom-and-bust excesses of the late 1980s and early 1990s.

Summary

In sum, we have seen greater caution being exercised by both borrowers and lenders in credit markets recently. Such tightening might be expected in an economy that has slowed after several years of rapid expansion and debt growth. Much of the firming to date has been selective and directed toward companies perceived to face an uncertain future in the new economic environment and to leveraged companies that are vulnerable to a period of slowing sales and profits. Overall, however, credit flows have been well maintained, and lending institutions are in much better financial health than a decade or so ago. Importantly, reports from small businesses are relatively upbeat with regard to the availability of credit. Although risky borrowers face close scrutiny, banks apparently have continued to accommodate the needs of their creditworthy business customers, while bank lending rates, on average, have moved lower.

NFIB®
The Voice of Small Business

Statement of

William C. Dunkelberg
Chief Economist

National Federation of Independent Business

Subject:	**Credit Availability and Cost in the Small Business Sector of the U.S. Economy**
Before:	**House Small Business Committee**
Date:	**May 17, 2001**

National Federation of Independent Business
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In the March, 2001 Senior Loan Officer Survey on Bank Lending Practices, between 25% and 33% of the domestic banks (54 large domestic banks and a number of bank branches) surveyed reported that they toughened terms on Commercial and Industrial (C&I) loans to small firms (terms included the interest rate charged, the spread over prime, collateral requirements, loan fees and loan covenants).

This "tightening" is not particularly apparent to most small business borrowers. There are a number of possible reasons for this:

1. Since "deregulation" and the advent of "risk based pricing," banks say NO less often and instead adjust loan terms in response to changes in risk.
2. After 10 years of expansion, small business balance sheets look very good. Standards may have risen, but most firms find that they can still qualify for loans. In addition, a slowing economy reduces credit demand.
3. There may be long lags between the adjustments made by "money center banks" that are closely attuned to changing market and economic conditions and the responses of thousands of smaller commercial banks in the economy.
4. Many smaller commercial banks respond to local or regional economic conditions that can vary widely over time and at any point in time.
5. New forms of financing including leasing (reported as the method of financing for 10% to 15% of NFIB capital expenditures) and credit cards (the Fed's NSSBF reports use by about 50% of small businesses) reducing dependency on banks and making changes in their lending standards less noticeable.

The first part of this testimony examines the evidence of "tighter lending standards" among small businesses as reported in the monthly surveys of the National Federation of Independent Business membership (over 500,000 member firms). The second part compares NFIB measures of credit availability to the measures provided by the Federal Reserve Board's 2001 Senior Loan Officer Survey on Bank Lending Practices

NFIB MEASURES OF CREDIT MARKET CONDITIONS

NFIB began its economic survey program in 1973, selecting a random sample of its membership to receive a questionnaire regarding actual and expected spending plans, expectations for the future and credit market experiences, etc. These surveys were conducted in the first month of each quarter through 1985 and then monthly starting in 1986. NFIB's membership includes over 10 percent of all employers in the U.S. and their firms are subject to the same economic forces that non-member firms experience. Thus, the findings from the survey provide a reliable near-term measure of how well the U.S. economy is performing.

The following credit-related questions are included in the monthly surveys:

1.What is the single most important problem facing your business today?

Taxes	Quality of Labor	Financing and Interest Rates
Inflation	Cost of Labor	Cost/Availability of Insurance
Poor Sales	Gov't. Regulation	Competition from Large Business
Other ________		

2. If you borrow regularly (at least once every 3 months)as part of your business activity, how does the rate of interest payable on your most recent loan compare with that paid three months ago?

Much Higher	Same	Much Lower	Don't Borrow Regularly
Higher	Lower	Don't Know	

3. Are these loans easier or harder to get than they were three months ago?

Easier Same Harder Don't Know

4. Do you expect to find it easier or harder to obtain your required financing during the next three months?

Easier Same Harder Don't Know

5. If you borrowed within the last three months for business purposes, and the loan maturity (pay back period) was 1 year or less, what interest rate did you pay?________________

6.During the last three months was your firm able to satisfy its borrowing needs?

Yes No Did Not Want to Borrow

The charts attached show the time series responses of the NFIB membership on a quarterly basis (the first month in each quarter) since 1973. The pertinent highlights of the survey are as follows:

CHART 1 In the early 1980s, credit availability and cost were major issues. As many as 37 percent of all firms cited these problems as #1 for their businesses. For the past five years, these issues have received virtually no votes for the #1 problem.

CHART 2 The remarkable performance of the U.S. economy since 1983 has reduced the need to borrow for "survival" (as was the case in the early 1980s when inflation destroyed cash flow). Regular borrowing activity has been historically low for a decade or more.

CHART 3 The net percent of firms reporting that loans are harder to get has been historically low for a decade. Capital markets have been and remain friendly to small business borrowers. In the most recent survey (April), a net seven percent of all firms in the Mid-Atlantic states and five percent in the East North Central states reported credit harder to get on the last attempt, just above the national average of three percent. The lowest was zero percent in New England.

CHART 4 Interest rates on short-term loans have been around ten percent for over ten years now and are falling in the current environment. Interest rates change frequently (usually in response to changes in Fed policy) as can be seen in CHART 5. Today's rates are half of those paid in the early 1980s.

CHART 6 Small firms generally expect credit conditions (presumably managed by the Fed) to be "tightening" by a small percentage (the percent that expect credit conditions to tighten less the percent expecting conditions to ease), but for the past decade, expectations about credit market conditions have been quite stable. This stability reflects small business owner confidence in the economy.

The data, collectively, indicate that credit is not hard to get, is becoming cheaper and that financing the ongoing operations of small firms is not a problem in this economy. In January, 1995, 37 percent of all firms reported "all borrowing needs satisfied." Six percent indicated this was not the case. In April, 2001, the comparable figures were 35 percent and 6 percent, not statistically different. There have been major regional differences at times with Mountain States and New England exhibiting some large fluctuations in the past. But, currently, there is little difference across regions in reports on credit availability. Overall, firms are relatively (compared to historical responses) pleased with their experiences with banks in particular and capital markets in general.

NFIB AND THE SENIOR LOAN OFFICER OPINION SURVEY

CHART 7 shows the relationship between the NFIB measures of credit market tightness and the Fed survey of loan officers at major banks. Casual empiricism indicates that there is only a loose relationship between the Fed measures of "tighter standards" and "increasing spreads" and the percent of NFIB members reporting loans "harder to get." There also appears to be a lag in the relationship – large bank loan officers report changes in credit availability and cost well ahead of changes in the NFIB measure.

Empirically, the best "fit" between the Fed measures and the NFIB measure is a 6 quarter lag (CHART 8). It appears that the percent of NFIB members borrowing regularly who report loans hard to get historically peaks about a year and a half after the percent of loan officers reporting higher lending standards peaks in the Fed survey. Thus, there appears to be a long and "loose" lag between the time that money center banks sense changes in the capital markets and translate those pressures into changes in lending standards and the time those changes are transmitted to small borrowers by the other 9,000 commercial banks making C&I loans.

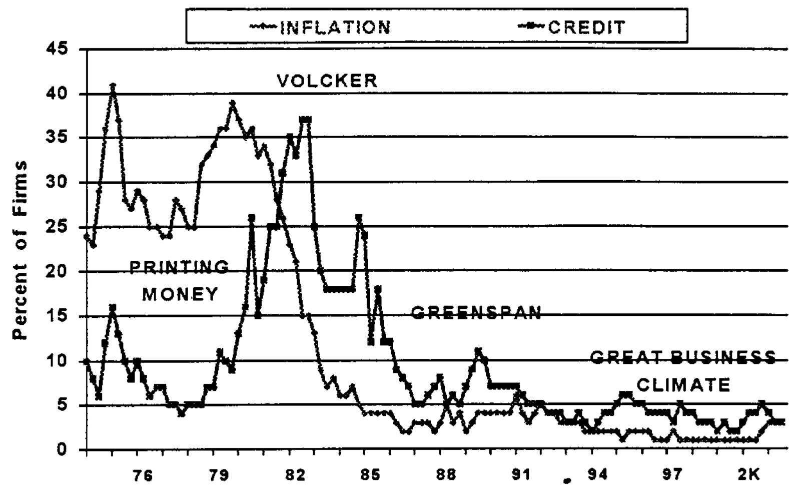
CONCLUDING REMARKS

The data I have presented outlines current credit conditions for the small business population. Individual small business owners will encounter differing situations depending on everything from current business performance to the owner's ability to shop the market. In order to understand what is transpiring, one must be careful to distinguish between prevailing conditions and individual experiences.

NFIB
4/2001

CHART 1

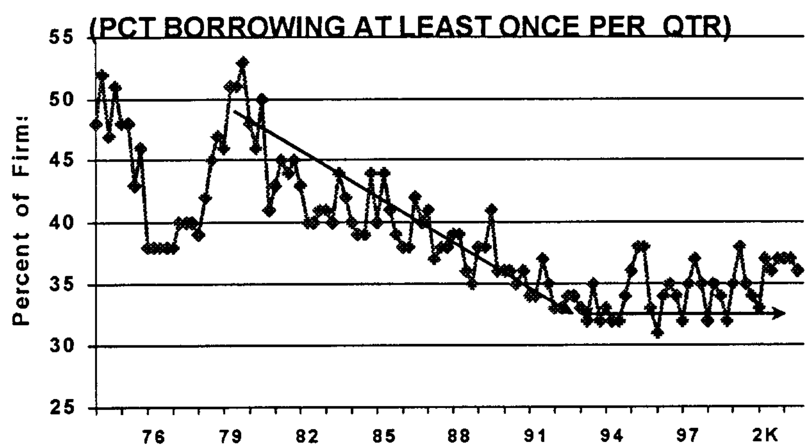
MOST IMPORTANT PROBLEMS



NFIB
4/2001

CHART 2

REGULAR BORROWING ACTIVITY

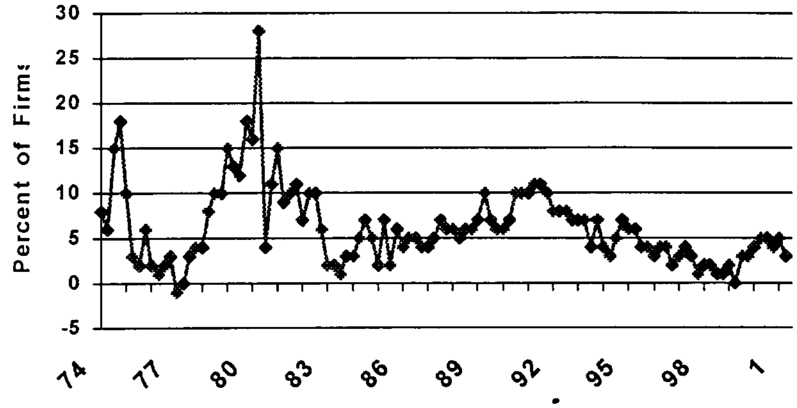


NFIB
4/2001

CHART 3

SMALL BUSINESS CREDIT PROBLEMS

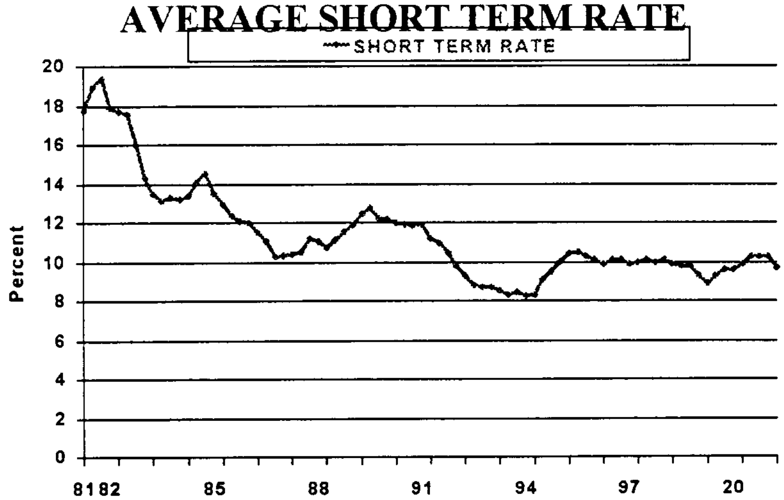
(% HARDER TO GET - % EASIER)



NFIB
4/2001

CHART 4

AVERAGE SHORT TERM RATE

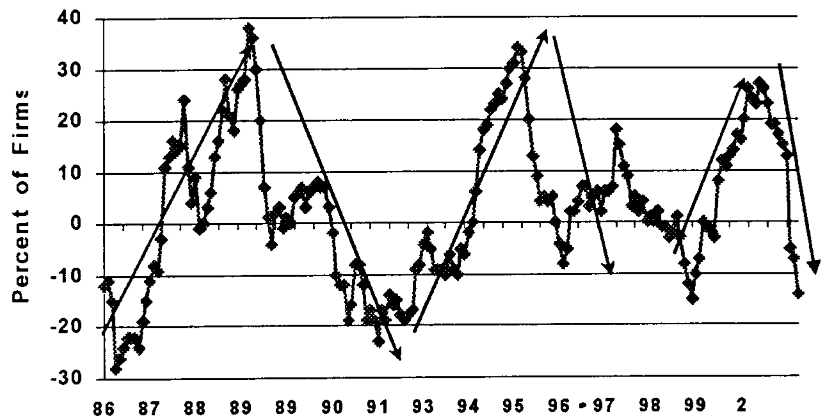


NFIB
4/2001

CHART 5

NET PERCENT REPORTING HIGHER INTEREST RATES

[ON THE LAST LOAN]



NFIB
4/2001

CHART 6

EXPECTED CREDIT CONDITIONS

(% EXPECT " EASIER" - "HARDER")

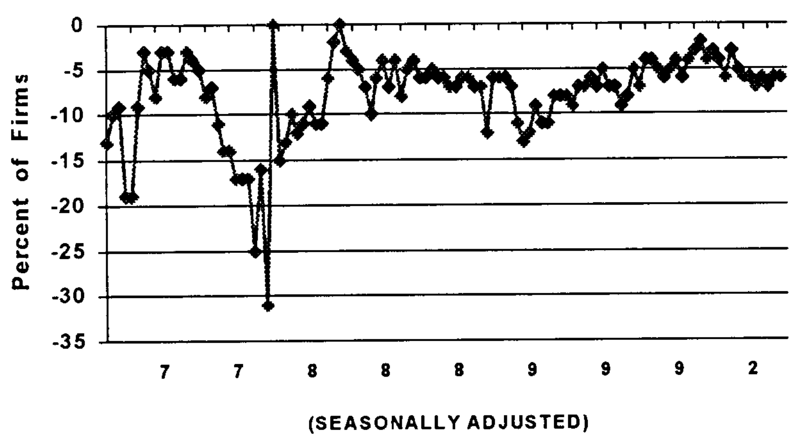


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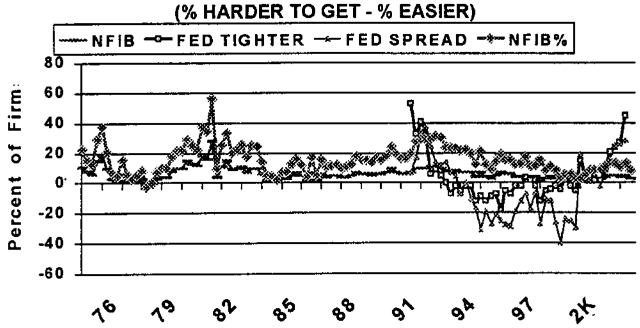
CHART 7

SMALL BUSINESS CREDIT PROBLEMS

(% HARDER TO GET - % EASIER)



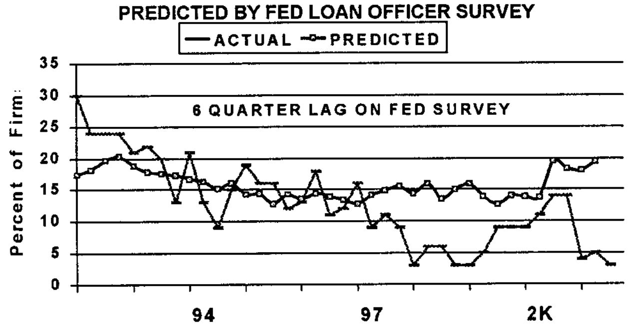
NFIB= net percent reporting loans harder to get; NFIB%= net percent reporting "harder divided by the percent of firms reporting regular borrowing activity.

NFIB
4/2001

CHART 8

SMALL BUSINESS CREDIT PROBLEMS

PREDICTED BY FED LOAN OFFICER SURVEY



This chart predicts the percent of those that borrow regularly that reported loans harder to get the last time a loan was sought.

PADGETT BUSINESS SERVICES FOUNDATION

STATEMENT

Leslie S. Shapiro

President, Padgett Business Services Foundation

U.S. House of Representatives Committee on Small Business

HEARING

ACCESS TO CAPITAL FOR SMALL BUSINESS

May 17, 2001

1200 G STREET, NW • WASHINGTON, DC 20005 • TEL: (202) 434-8743 • FAX: (202) 628-3497

STATEMENT

Leslie S. Shapiro

President, Padgett Business Services Foundation

U.S. House of Representatives Committee on Small Business

Hearing

Access to Capital for Small Business

May 17, 2001

My name is Leslie S. Shapiro, president of the Padgett Business Services Foundation located in Washington, D.C. Padgett Business Services is a corporation headquartered in Athens, Georgia, with 275 offices located throughout the United States. It offers accounting and tax services to small business. Small business is defined by Padgett as those businesses with under 20 employees. As a practical matter, most Padgett clients have fewer than five employees.

I am pleased to be here this morning to offer our observations on a subject we believe to be very important to small business. It is this belief that prompted us to agree to amass information and report out on it when asked only last week to do so. In this connection, we immediately sent a request to our offices to provide us input relative to their clients' experiences in seeking and obtaining loans and credit lines. Consequently, the information we have is only a few days old. While not fleshed out in detail, we hope it will give you a snapshot of the experiences of owners of small businesses in an area critical to their fulfilling the American dream.

There are some "givens" in the equation we are considering. Small business is critical to the viability of the nation's economy. The other is that almost all small businesses need financing. This is particularly so for start-up businesses. Further, most of the loans small business owners are looking for do not involve huge amounts of money. The loan range being sought normally is $250,000 or less. In most instances, the amounts are under $100,000.

The goal I believe we all are seeking is to make financing available with as few complications as possible, recognizing that banks and other financial institutions also are in business. This always has been the goal. Our findings show that achieving the goal has not gotten easier or even has remained the same. Our clients' views reflect that, and their experiences indicate the goal now may be more difficult to reach than before.

Gone are the days when a prospective small business owner need only show a bank that he or she is a good person with a good idea. Other factors must be added, among which are that the person seeking assistance must have a strong financial background, and there is a need to furnish compelling support demonstrating that the good idea will work. Both require staggering paperwork. After all that, applications for financing often are turned down.

Our information reflects that many entrepreneurs who do not have the strong financial backing to which I just referred are asked to offer their homes and the like as collateral. Even if the applicant is willing to do so, the fact a home is heavily mortgaged or being refinanced means this avenue is not possible. Yet, our responders indicate that most loans they receive are personal and tied to home equity. A California Padgett office owner observed the following:

> In California, I have never seen a bank give a loan to a small business on its own merits. All the loans are given as a second home loan. If you don't own a home or have enough equity, then you cannot get a loan from a bank. With rapidly rising home prices, this has allowed many clients to obtain loans. With home prices now falling in the San Francisco Bay area, the ability to get loans will be rapidly declining.

Further, one responder reported that if a lender is willing to make a loan to a small business for expansion, the demands made by the lender have been extremely high. For example, one bank requested substantial repayment of a loan within 12 months of when the loan was made. The small business owner may just be beginning to experience the fruit of the expansion after a year. He or she is not able to pay back the loan as quickly as the bank expects. We do not know if this story indicates a trend.

To demonstrate that a good idea will work more likely than not is something that cannot be accomplished. No one can show with certainty that there will be success flowing from a good idea. This deflates the initiative of those who want to start a business or to expand an existing one.

While there is obvious recognition that a lender has a vested interest in some comfort level in believing an idea will work, our responders feel that the demands they are facing are unrealistic. For example, why should a small business owner be able to receive immediate financing for a truck (which loses value as soon as it is driven from the dealership) being purchased for the owner's business use and not qualify for a business expansion loan of the same amount as the truck loan because assurance of the success of the expansion cannot be demonstrated to the satisfaction of the bank? Why should small business owners find it more realistic to lease equipment rather than to endure the anxiety and often futility of trying to obtain a loan to purchase it?

Padgett also has been reminded from our survey results that prospective small business owners and those already owners often must use the assistance of their accountants and attorneys to apply for financial assistance. The costs for such assistance are such that loan applicants cannot afford these services.

Our responders in the main have observed that small business owners are being driven away from the national banks, particularly the large ones. This is because of the difficulty in obtaining financing and the bureaucratic business methods of those banks. One responder stated that when a national bank moved into his rural community, approximately 25 of his small business clients patronized the new bank. This was less than two years ago. Of those 25 clients, only one remains the new bank's customer. Another complained of the time it takes for a large bank to make a decision, and when the decision is made, it usually is unfavorable. Yet another responder stated that the bank in his locality referred the application to a bank branch in another part of the country, apparently because of subject matter dispersion of the bank's operation. There is one notable exception in the responses we received. In Minnesota, a national bank began a program a year or so ago. A small business owner who has been in business at least two years, has experienced a profit, and has good credit scores qualifies for an unsecured credit line of up to $50,000. The application is a two page form, and the applicant has an answer is about two business days. However, the almost unanimous finding is that the small businesses Padgett offices serve prefer local banks for their financing needs.

Finally, it should be observed that interest on loans does not seem to be a factor. Padgett's clients often extend the credit lines on their credit cards in order to finance expansion of their businesses or to have the financing needed to get their businesses off the ground. We consider this commentary based on fact to warrant the attention of all champions of small business.

Candor suggests stating the obvious. There are start-up businesses and small businesses in operation that should not be in business and, as a result, should not qualify for loans. However, many, if not most, small business owners would benefit from easier access to capital and would not cause significant risk to lenders. We applaud this committee for its recognition of this fact and hope that such access with a minimum of frustration will soon be a reality. It would be an important reaffirmation to our commitment to small business and our nation's free enterprise system.

Thank you for this opportunity to present our views this morning. As always, Padgett Business Services and the Padgett Foundation will be pleased to work with you in any capacity you believe will be helpful.

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AMERICAN
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World-Class Solutions,
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Since 1875

Testimony of

Arthur C. Johnson

On Behalf of the

American Bankers Association

Before the

Committee on Small Business

Of the

United States House of Representatives

May 17, 2001

Testimony of Arthur C. Johnson
On Behalf of the American Bankers Association
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United States House of Representatives

May 17, 2001

Mr. Chairman, I am Arthur Johnson, Chairman and CEO of United Bank of Michigan, Grand Rapids, Michigan, and a member of the American Bankers Association's Government Relations Council. I am pleased to be here today on behalf of the American Bankers Association ("ABA"). ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the country.

I want to thank you, Mr. Chairman, for holding this hearing to discuss credit conditions, particularly with respect to small businesses. Let me assure you that meeting the needs of our small business customers is extremely important to every bank – it is vital to the health of our local economies and the success of our banks.

At United Bank, we have 9 banking offices, 5 in rural communities and 4 in the greater Grand Rapids metropolitan area. The western Michigan economy, in addition to its agricultural component, has a substantial manufacturing base. This sector's growth is dominated by young, small businesses. As is true for the rest of the country, it is these small companies that are providing the vast majority of the job growth in our area. We understand the importance of bank financing to these enterprises and to our community. United Bank, like banks across the country, has established its reputation based upon a long-term commitment to our customers. Unsophisticated investors who may be unable to stay the course, and venture capitalists who may be unwilling to stay invested for the long-term, just do not have this type of commitment.

Simply put, we are in business to help our customers and communities for a lifetime, not just this week or this year.

We cannot ignore, however, changes in our local and national economies. The economy has certainly shifted into lower gear and therefore, our approach must naturally be more cautious. Any experienced driver knows to slow down when the road gets rough. The same is true of bank lending as economic conditions get bumpy.

In my testimony today, I would like to make three points:

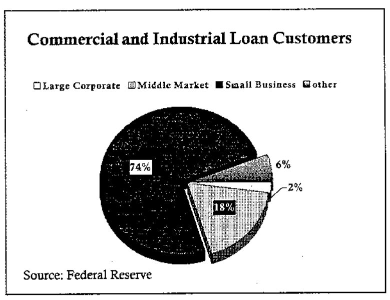
- Small business lending is a core part of banking's business;
- Small business lending continues to grow, but economic conditions suggest caution; and
- Congressional action can help small business access to credit.

Let me discuss each in greater detail.

Small business lending is a core part of our business

Small businesses look to their hometown bankers for leadership to help them survive and thrive. In fact, banks are the primary source of credit to small businesses and farmers throughout this country. As Chart 1 shows, small businesses make up nearly ***half*** of all commercial and industrial loan customers and ***three-quarters*** of all business banking customers. Adding middle market customers pushes the percentages above 90 percent.

Chart 1



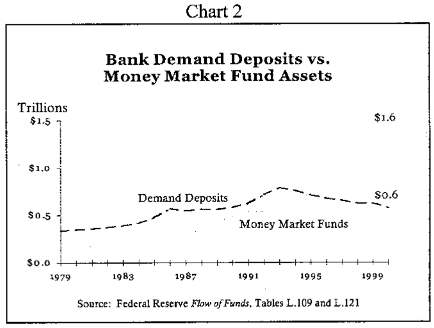
Today, banks have more than $230 billion in loans outstanding to small businesses – almost a 10 percent increase from the last year's level – and we continue to meet the needs of small businesses.[1] Moreover, according to the U.S. Department of Agriculture, banks are the primary source of credit for farmers.

At United Bank, we have $240 million in assets, with roughly 60 percent devoted to loans to businesses of all types. More than 99 percent of our business lending is to small businesses. Moreover, we specialize in SBA loans, which constitute 35 percent of our small business loans. For United Bank, loan demand was very strong in 2000, growing at a 15 percent annual rate, and continues to grow at about 8 percent this year.

Banks are keenly aware of the needs of small business because most banks are themselves small businesses. In fact, ***half*** of the 8,600 banks in the U.S. have fewer than 30 employees and nearly 14 percent have fewer than 10 employees.

Finding funds to support loans is the number one challenge facing banks today. This is where banks presently need the most assistance in lending to small businesses, making this the ideal time to explore new options to ensure that lenders have a reliable, dependable source of funds to meet small business borrowers' credit needs. Such efforts are crucial to assisting banks in their continued role as engines of local economic development.

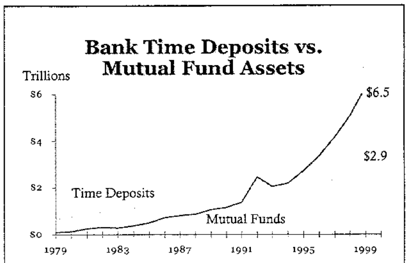
Chart 2



Simply put, banks are struggling to attract deposits to fund loans. The past two decades have seen major changes in the financial services industry, with many new competitors vying for the consumer's dollar. Our biggest competition is Wall Street, not the bank across Main Street. Growth in money market funds, stock prices and mutual funds has lured core deposits away from

[1] There is also an additional $269 billion in commercial real estate loans to small businesses, agricultural production loans, and loans secured by farmland. This data is for June 1999 to June 2000.

us. Chart 2, shows the dramatic shift out of bank checking accounts ("demand deposits") and into money market funds. Similarly, Chart 3 shows that the money that used to be in savings accounts ("time deposits") at banks is increasingly going into mutual funds.



Source: Federal Reserve *Flow of Funds*, Tables L.109 and L.121-123.
Time Deposits are small time and savings deposits plus large time deposits.

Chart 3

The high regulatory, examination, and compliance costs make it very difficult for banks to be competitive with these other firms. Although Wall Street competes with us for savings dollars, those Wall Street dollars do not end up funding the needs of small businesses. That job is left to the bank.

"Credit Caution" is the Watchword

Over the last half-dozen years, bank business lending grew rapidly, reflecting the strong economy (see Chart 4). Over the last year, however, economic conditions have downshifted and so must our approach to lending. The local economy that my bank serves is highly dependent upon manufacturing. United Bank has been in business for over a century – we know that economic downturns hit us sooner and harder, and will last longer, than other regions of the country. Therefore, we must watch for early signs that the winds have changed, and prepare sooner than perhaps others of my colleagues around the country.

Chart 4

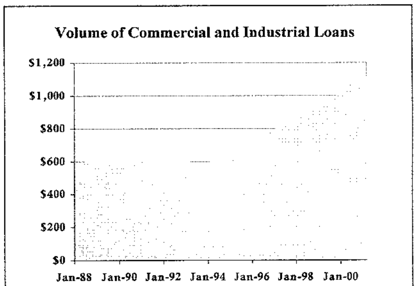
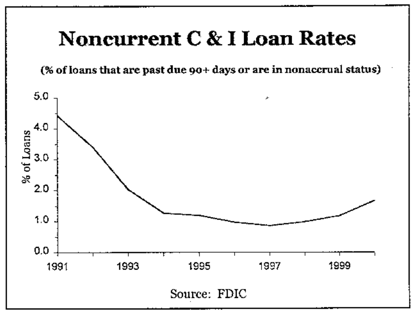
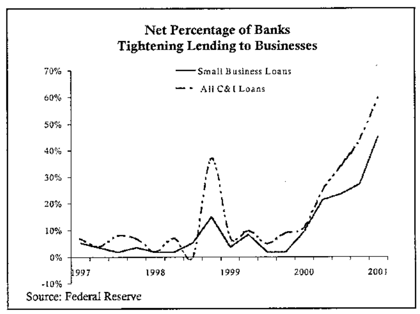


Chart 5



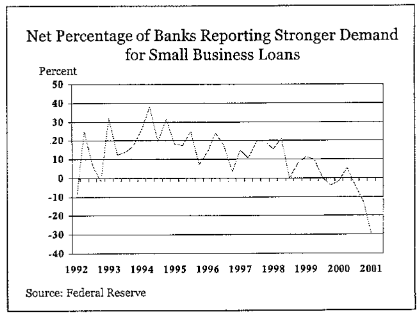
As you noted in your invitation letter, Mr. Chairman, banks have been tightening their underwriting standards. This process began following the Russian default in August of 1998. Credit markets worldwide were shaken, and the default served as a reminder of how quickly good times can fade. A slight rise in bank non-performing loans over the last several years has also put a real face on difficulties businesses have been encountering (see Chart 5).

Chart 6



As the economy continues to slow, the process of tightening has become more widespread (see Chart 6). The Federal Reserve Senior Loan Officer Survey you mentioned, Mr. Chairman, does indicate that more than 43 percent of banks tightened small business lending standards ***somewhat***, while the remaining 57 percent kept standards basically unchanged. Tightening of lending standards was even greater for large and middle-market firms. Not surprisingly, the uncertain economic outlook was the reason most frequently cited for these adjustments, followed by worsening of industry-specific problems and a reduced tolerance for risk.

Chart 7



Let me be very clear: We are in the business of lending, and that is what we intend to do. Good creditworthy borrowers will always have access to funding and we are always mindful of our role in helping our economy return to sustainable growth. However, the risks of lending today are certainly greater than they were a year or two ago. We are looking more carefully at our loans and asking our customers more questions about their business plans and whether those plans accurately reflect the slowdown in economic activity. Not surprisingly, nationally the demand for business loans has slowed with the economy (see Chart 7). Such conservative approaches to both borrowing and lending are prudent in the face of uncertain economic times.

I would like to make one more important point regarding today's lending environment. There is a tendency to compare the current slowdown today with the credit conditions in the early 1990s. There are two areas to consider: the financial condition of banks and the regulatory environment. Fortunately, the financial condition of the banking industry today is much better than it was in the early 1990s. Bank capital plus reserves for loan losses has climbed to record heights and is nearly $600 billion -- ***two and a half times*** the capital level in 1990 (see Chart 8). As I mentioned, non-performing loans are still low by historical standards. And banks have diversified their sources of income over the last decade, which has enhanced an already strong and stable revenue base. Simply put, banks have the financial strength to weather any storm and to continue to lend to creditworthy borrowers.

Chart 8

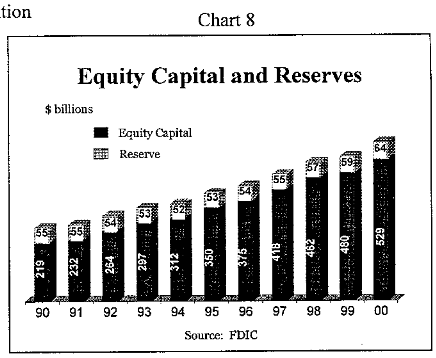
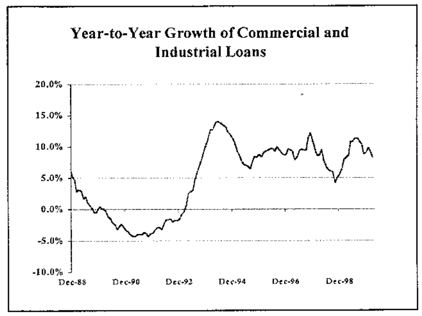


Chart 9



The regulatory environment in the early 1990's was not one that encouraged lending. Every loan, particularly related to real estate, was scrutinized. The message sent to bankers then was "make no mistake in lending" and the result, as Chart 9 shows, was ***negative*** growth in lending for several years. Obviously, neither the regulators nor banks want to repeat that experience. In today's environment, it is critical that banks and bank regulators take a balanced, thoughtful approach to lending. Chairman Greenspan summed this up when he said: "Though lenders will be viewing new transactions with greater caution than they did a couple of years ago, both bankers and their supervisors should now guard against allowing the pendulum to swing too far the other way by adopting policy stances that cut off credit to borrowers with credible prospects."[2]

Certainly, the aggressive rate cuts by the Federal Reserve have eased some of the pressure on business loans outstanding today (as they are typically tied to the prime lending rate which has declined) and has lowered the average cost of new loans.

Congressional action can help small business access to credit

You asked in your letter of invitation, Mr. Chairman, what changes could be made that would facilitate access to credit for small businesses. I will discuss briefly some ideas that I believe would help, but before I do, I want to acknowledge some important laws that have recently been enacted that will help. In particular, the merchant banking provisions in the Gramm-Leach-Bliley Act of 1999 (GLB Act) will serve an important function in providing needed capital to businesses. Start-up businesses often lack equity, thereby limiting their ability to qualify for debt financing to grow their businesses. The merchant banking provisions in the

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[2] Remarks before the America's Community Bankers Conference, New York, New York, December 5, 2000.

GLB Act will allow banks to take an equity stake in these firms and provide these businesses with additional financial resources.

The merchant banking powers will help preserve Main Street by assisting in the intergenerational transfer of family-owned businesses. Implementation of these provisions by the regulators must be done carefully so as not to discourage the very purpose this provision was designed to address. ***Repealing the estate tax would also help these intergenerational transfers for family-owned businesses considerably.***

The GLB Act also expanded the collateral that could qualify for Federal Home Loan Bank advances. This allows small business and small agri-business loans to qualify as eligible collateral for advances and will certainly improve the funding for many Main Street businesses. Again, implementation of these laws by all twelve of the Federal Home Loan Banks must be done in a way that promotes these benefits.

Let me now turn to a very important issue related to the SBA Guaranteed Loan Program. This Program can be one of the most cost-effective, high impact tools that Congress can provide. The Program's resources are targeted to small businesses that do not typically meet bank-underwriting standards. The guarantee helps protect banks against losses and provides credit that would otherwise be unavailable – a win-win situation and an example of an effective public-private partnership. For these small businesses, the assistance can make a critical difference between financial survival and failure.

My bank specialized in SBA lending, but we have scaled back considerably because of the rising fees associated with this program. These loans – ***which require considerable expertise by bank employees*** – are quickly losing their attractiveness for banks like mine. The recent budget proposals that are being suggested – which would once again raise fees for both the borrower and the lender for the 7(a) program – are likely to spoil this product altogether, making what is now a marginal business completely uneconomical. I also worry that the timing of such a change will reduce the credit available for these small business borrowers as they seek access to funds in a slowing economy.

There are also tax incentives that would be helpful. I've already mentioned how the repeal of the estate tax would help the intergenerational transfers of small businesses. Below I've briefly described a few additional tax provisions.

FFARRM Accounts: Farmers, fishermen and ranchers often have incomes that change dramatically from year-to-year. The Farm, Fishing and Ranch Risk Management Accounts (FFARRM accounts) allow participants to deposit up to 20 percent of taxable income in a year in a special bank account. Participants would make withdrawals from the account over the next five years, with the withdrawals being taxed as income in the year the withdrawal takes place. This allows farmers, fishermen and ranchers to smooth income for tax purposes, providing an incentive to save for bad times and manage the inherent financial risks of their businesses.[3] FFARRM accounts would provide a badly needed source of funding for all types of lending.

Strengthen Aggie Bonds: Aggie bonds are state industrial revenue bonds for agricultural borrowers. These bonds represent a cost-effective method of providing reduced interest rate loans to young and beginning farmers for capital purchases of farmland and equipment. Unfortunately, aggie bonds are subject to a federal volume cap on industrial revenue bonds (IRBs) and must compete with industrial projects for bond allocation. This results in insufficient volume for aggie bond programs. Therefore, small beginning young farmers and startup businesses in rural and under-served areas are often left without adequate access to aggie bonds. Aggie bonds should be exempt from the state bond volume caps. This would encourage states to start aggie bond programs and provide more beginning farmers with low-cost capital.

Improve and Expand Subchapter S: In order to create greater opportunities to raise capital and preserve small business lending, improvements in Subchapter S should be made. This would help many small businesses, including small community banks.

To help small businesses, the following changes to Subchapter S are recommended:

[3] Senators Grassley (R-IA) and Baucus (D-MT) have recently introduced S. 313, the Farm, Fishing and Ranch Risk Management Act.

- Expand the shareholder threshold from 75 shareholders to 150. Expanding Subchapter S eligibility to more small businesses would eliminate an artificial constraint on small businesses to raise capital.

- Expand the type of shareholders. Currently, Subchapter S eligibility requirements exclude many types of institutional shareholders, such as family limited partnerships and individual retirement accounts thus limiting the sources of potential capital.

- Authorize a second class of stock. Currently, Subchapter S businesses can only issue one class of stock. This restriction on stock offerings constrains the ability of small businesses to raise capital.

- Modernize the passive income rules. Currently, Subchapter S businesses are subject to a corporate-level tax on excess passive investment income. Modernizing the passive investment rules would encourage the growth of small businesses and alleviate unnecessary investment costs.

Conclusion

Small businesses are vital to a strong economy and often the centerpiece of banks' lending activities. Bankers know the critical role we play in helping these businesses grow and be successful, and we know the broader implications for job growth and economic vitality of our local communities. Regardless of the economic cycle, we are always looking to meet the needs of creditworthy borrowers. We must also be cognizant of changes in economic activity. The risk of lending today is far greater than it was a year or two ago and our lending decisions must naturally take this into account. Of particular importance to small business lending has been the SBA Guaranteed Loan Program. I would urge a careful review of recommendations to add costs to both the lender and the borrower on these programs, as they will likely reduce the amount of credit to small businesses.

Testimony of

Douglass M. Tatum, CEO
Tatum CFO Partners, LLP

Before the
House Committee on Small Business
On May 17, 2001

"Access to Financing for Small and Growing Businesses"

Introduction and background

Good morning, Mr. Chairman and Members of the Committee. My name is Douglass M. Tatum, and I am Chief Executive Officer of Tatum CFO Partners, LLP, which is headquartered in Atlanta, Georgia. I would like to start by commending each of you for reviewing an issue that is enormously important to the health of our economy. Mr. Chairman, it is not an understatement to quote from your letter inviting me to testify before this Committee that "it is imperative for our Nation's economy that small and midsize businesses access the capital necessary for growth and survival.

The National Commission on Entrepreneurship recently conducted focus groups with over 250 CEOs of entrepreneurial firms across the country. In its report, entitled Building Companies, Building Communities (July 2000), the Commission concluded that the lack of available capital at a reasonable cost is a critical problem facing entrepreneurs.

The recent U.S. economic expansion has been a period of substantial growth in employment. According to recent studies by the Kauffman Center for Entrepreneurial Leadership (Global Enterprise Monitor, 1999, 2000) and Cognetics, Inc., the greatest growth in employment has come from emerging small and mid-size entrepreneurial firms (principally those with under 100 employees). For example, Cognetics data indicate that

84% of net, new job growth for 1992-1996 was in firms with under 100 employees (Corporate Demographics: Whose Creating Jobs? 1997).

Comments on the "No Man's Land Capital Gap"

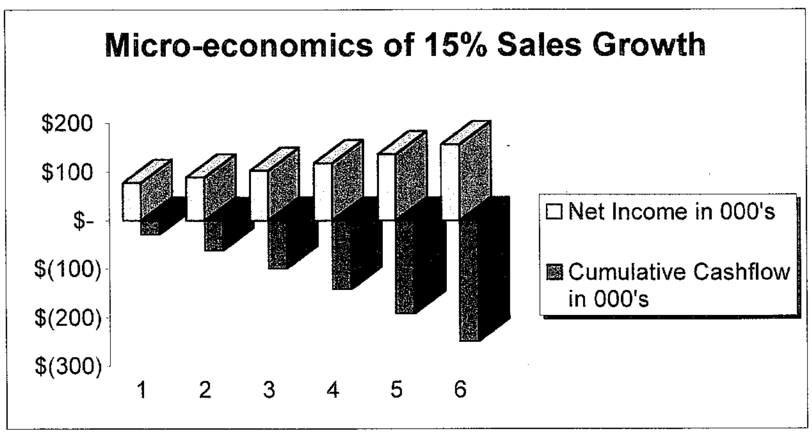
My testimony on the matters before the Committee today comes from the perspective of serving as CEO of the largest CFO firm in the country with over 300 partners located geographically in 23 offices. Our partners provide CFO assistance and serve as CFOs for companies ranging from start-ups to Fortune 2000 multinationals; and, on any given day, we are responsible for purchasing tens of millions of dollars of capital from regulated and non-regulated financial institutions and professional private equity investors (such as venture capital firms).

In addressing the issues surrounding the lack of capital from our perspective, it is important to summarize the microeconomics of the borrower first and then the lender.

The Borrower:

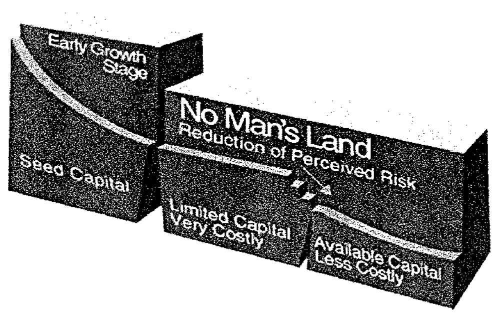
We would suggest based on our firm's collective experience that the bulk of the Capital Gap problems experienced by entrepreneurial CEOs coincides with his or her company's sudden growth accompanied by a transition period during which the company becomes "too big to be small and too small to be big." We refer to this economic transition period as "No Man's Land." During this period of growth, the company is extremely fragile and can quickly lose its economic momentum due to a lack of management, human resources, infrastructure, and to the point of these hearings, a lack of reasonably priced capital. Accompanying my written statement, there is a small booklet entitled, No Man's Land: Where Growing Companies Fail©. This material is a very simple summary of the types of issues experienced by these companies during this transition period, and it might be helpful to you in understanding our perspective on the issues before the Committee.

The problem for these companies starts with growth itself. Growth in revenue drives growth in assets, creating demand for capital and a perpetually cash-starved borrower--even with significant profitability as outlined in the first chart below, labeled as "Micro-Economics of 15% Sales Growth."



This chart illustrates the dramatic difference between profitability and cash flow, based on a $2.8 million company growing at 15% per year. These companies are generally thinly capitalized to begin with, and as indicated above, generally are in a risky transition. As indicated in our booklet, No Man's Land: Where Growing Companies Fail©, the key to raising capital for these businesses is creating a reduction of risk for the borrower.

The second chart, below, illustrates the general affect on the availability and the cost of capital for those businesses that can reduce the risk of the business as presented to the borrower. In practice, this is affected through the use of the business' assets as collateral and as the business proves itself capable of sustaining profitability over several years—i.e., reduces its perceived risk to the Capital Provider.



The Lender:

Providers of Capital to these emerging growth companies address the risk problem through intense account and collateral management. In preparation for this testimony, we polled several of our partners and other senior industry executives with extensive experience in both the regulated and non-regulated financial imarkets. Part of our review included a confidential evaluation of the economic pricing and microeconomic models of both types of lenders. In summary, both regulated and non-regulated institutions provided data indicating that the actual cost of collateral management, account management, and loan acquisition and origination for smaller loans (significantly below $1,000,000) can be upwards of 14%. These fixed costs when added to the normal risk-adjusted interest rates create an overall cost to the borrower that becomes the real issue. The costs associated with this risk management becomes less significant with the increased size of the loan, creating a funding gap of reasonably priced capital between what a company typically raises at start-up from savings, friends, family, etc. ($100,000 to $250,000) and what we estimate to be the level ($1,000,000) that becomes economically viable from both the borrower's and lender's perspective.

Final observations

There is no doubt that some of these financing needs are being met by a variety of sources, including the SBA and particularly the SBIC programs, banks and other non-regulated lenders interested in addressing the needs of this market. However, we would argue that until a more cost effective risk management process is developed, many of the regulated institutions will continue to use rules-based credit scoring as part of their underwriting procedures for smaller companies--effectively eliminating many of these companies from consideration. In addition, the general trend will be to target this type of growth capital to larger business customers and larger loans where the costs outlined above are not as significant to the overall pricing.

Finally, there is one other item that we believe should be brought to your attention. In our firm's opinion, current tax policy compounds the difficulty in retaining critical capital for a company during the formative growth phase because it requires an expanding business to pay a tax "dividend" at time when it may be cash flow negative and unable for the reasons outlined above to obtain reasonably priced capital from lending institutions to fund its continued growth in sales and jobs.

Congressmen Jim DeMint (S. C.) and Brian Baird (WA) and their staffs, and others, have been very helpful in working with our firm to develop and refine a tax deferral proposal for emerging growth businesses designed to address this problem. We hope that you will give it your consideration at the appropriate time when the proposal is introduced as a bill.

Concluding comments

In conclusion, I would like to thank each of you for the opportunity to appear before the Committee. I will be glad to attempt to answer any questions the Committee may have regarding the capital needs and financing issues facing growing businesses.

Douglass M. Tatum, CEO
Tatum CFO Partners, LLP

Douglass Tatum is a Partner and CEO of Tatum CFO Partners, LLP, a partnership of career financial officers serving early stage companies, middle-market companies, and large corporations. The firm, which began in Atlanta, has expanded on a national basis, with over 300 partners in 23 cities.

Prior to joining Tatum CFO, Mr. Tatum shared the responsibilities of the Office of President of Archibald Enterprises in Tallahassee, Florida, a corporation comprising three major companies including: Homes and Lands Publishing Corporation, the largest franchised real estate publisher in the United States; The Printing House, Florida's fourth largest printer; and Vista-Chrome, Inc, one of the country's largest state-of-the-art graphics and pre-press companies. Prior to his position as President of the firm, Mr. Tatum served as Archibald's Vice President for Research and Development and as Vice President of Finance.

Mr. Tatum's background also includes serving as Vice President of Operations for CMS/DATA Corporation, an international software company serving the legal market, and as Vice President and Chief Financial Officer of Skagfield Corporation, a national interior products manufacturer.

Mr. Tatum is a graduate of Florida State University where he earned a Bachelors Degree in Accounting and Finance (magna cum laude) and a Masters Degree in Accounting. He has been a part-time faculty member of Florida State University, where he taught accounting. Mr. Tatum has developed and conducted seminars for the Florida Institute of Certified Public Accountants and several other state accounting societies, covering computer acquisition as well as strategic business planning. He has co-authored a book and course for the Florida Institute of CPAs, Technical Tools and the MAS Approach to the Small Business Engagement, and has written several widely published articles on pre-press technology.

Mr. Tatum is a recognized expert on financing companies in transition, and is a frequent speaker presenting Tatum CFO's booklet, No Man's Land: Where Growing Companies Fail, to groups of CEOs throughout the country.

TATUM CFO

NO MAN'S LAND

WHERE GROWING COMPANIES FAIL

NO MAN'S LAND

Where Growing Companies Fail

INTRODUCTION

No Man's Land is that time in every company's life when it faces perhaps its greatest challenge - the challenge of growing up. It is the adolescent stage of corporate growth. Like human adolescence, No Man's Land should be a place of self-discovery, acquired discipline, and positive but difficult transition. Unfortunately, it often becomes an agonizing battle between the natural tendencies of a lonely entrepreneur and certain immutable laws of growth. The result is confusion, frustration, stagnation, and loss of employee morale which, if prolonged, lead to financial failure.

Through the years, we at Tatum CFO have observed a recurring phenomenon. Most entrepreneurs are simply unaware of No Man's Land. Furthermore, they are unaware that certain of their own natural tendencies prevent long term growth. This is understandable, for it is these very same tendencies, oddly enough, that have been the basis of their success to date.

Our purpose in writing this booklet is to identify four steps that must be taken in No Man's Land. We firmly believe that once taken, a company will have the foundation for unprecedented economic growth. We call these steps the "4 M's of Growth:"

- ***Understand Your MODEL***
- ***Realign With Your MARKET***
- ***Hire Your Senior MANAGEMENT***
- ***Raise Your MONEY***

NO MAN'S LAND

3

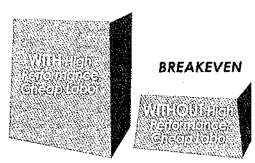
Understand Your Model

AN EXAMPLE: CHEAP LABOR

When customers are asked why they do business with an emerging company, they often answer "service." Most companies attract their first customers through high performance, cheap labor. Essentially, an entrepreneur and a loyal core of employees work harder to provide superior product and service less expensively.

But sustained growth cannot depend on a competitive advantage gained through high performance, cheap labor. The unrelenting economic reality is that a company must eventually grow with mostly average skilled people paid normal wages. This represents a fundamental change in a company's business "model." Without high performance, cheap labor, a company may no longer have a set of competitive advantages that provides enough customer value to earn a profit. If so, the company's business model does not permit growth. In fact, a company whose only competitive advantage is high performance, cheap labor must remain small to survive.

Customer's Perceived
Value of Product/Services



This transition from high performance, cheap labor to normal labor is but one example of many other changes and decisions that redefine a company's business model as it grows. The main point is that a company must first fully understand its existing business model and then constantly analyze it. By doing this, the company continuously subjects itself to a financial reality test, a discipline required for profitable growth.

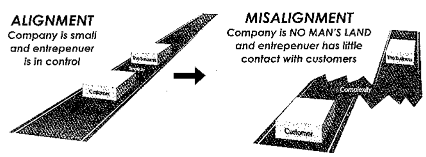
TEST WHETHER YOU ARE IN NO MAN'S LAND -

- *Are you experiencing unprofitable growth because the growth rate of overhead is exceeding the growth rate of sales?*
- *Are your employees misinterpreting sales growth as profit thereby raising their compensation expectations?*
- *Do you know the true cost of each individual product and service?*
- *Have you factored in the real cost of adding sales into your growth plans?*
- *Are you feeling an inability to follow through on compensation promises to employees?*
- *Do you know how much additional cash you will need to fuel accelerated growth?*

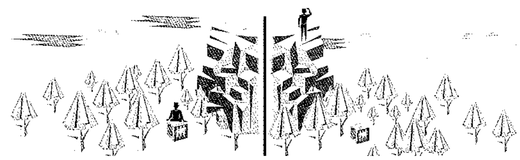
5

Realign With Your Market
AN OBJECTIVE PERSPECTIVE

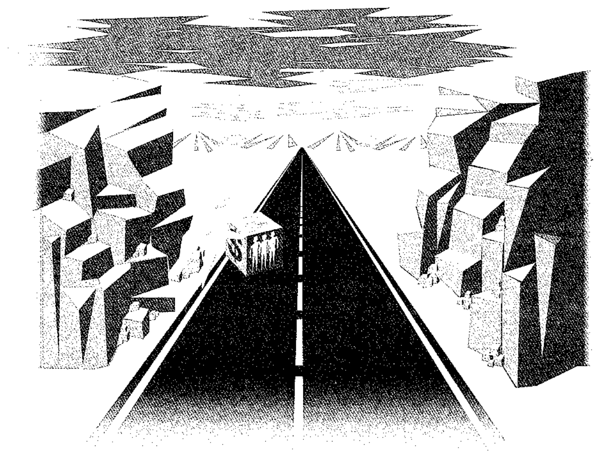
In its early stages, a company is driven by the entrepreneur's unique personality, skills and understanding of the market. Its business is characterized by a simple, non-filtered exchange between the customer and a single point of contact, the entrepreneur. The hands-on entrepreneur ensures that products, services and operations are aligned with customer needs. The entrepreneur directs quick changes to satisfy a specific customer. The result is that the company is simple for the customer to do business with and the customer receives the unique value of the company's products and services. The company is essentially market driven because of alignment.



With growth, the demand on an entrepreneur increases. Whether it's managing accounting staff, seeking capital or putting out fires in operations, less contact with customers occurs. The entrepreneur then becomes personally unable to maintain alignment. The result is that simplicity no longer characterizes the customer's relationship with the company. Ultimately the company loses its competitive advantage and its sales stagnate.



In order to continue growing, a company must realign with its market. Realignment begins only when an entrepreneur gains an objective perspective of the business and recognizes it is misaligned with its market. Once achieved, this objectivity leads, often for the first time, to identifying the company's real and potential competitive advantages. The understanding and analysis of one's business model is also fundamental to this process.



TEST WHETHER YOU ARE IN NO MAN'S LAND -

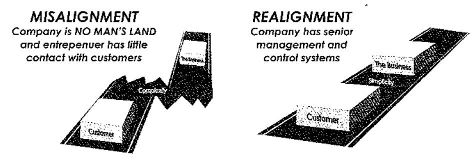
- *Do customers only want to deal with you?*
- *Is there undue stress between sales and operations?*
- *Do you have dissatisfied customers?*
- *Are your forever putting out fires?*
- *Are you having difficulty distinguishing your products and services from that of your competitors?*
- *Have your sales stagnated?*
- *Do you have an apparent lack of competitive advantage?*
- *Are you living on past reputation?*
- *Are you bored with your core business and beginning to focus on new products and services?*
- *Do new products and services reflect your personal interests and not necessarily your customers' needs?*

7

Hire Your Senior Management

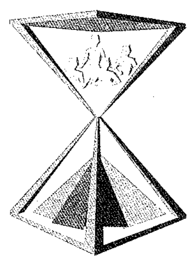
THE HOUR GLASS

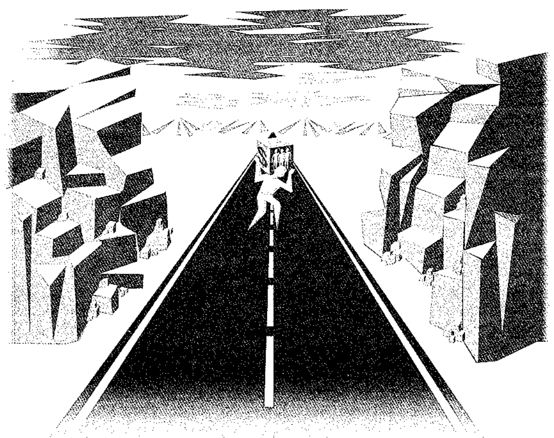
An entrepreneur can maintain alignment and ensure simplicity for customers when a company is small. However, once alignment is lost in a growing company, gaining it back requires senior management and a control system. The entrepreneur must hire and delegate to senior management the responsibility of implementing and managing this control system.



Certain unique, customer oriented skills must also be delegated to this senior management structure. The entrepreneur's focus must change from doing to designing and possibly from creating to managing others' creativity. What the entrepreneur does well, the organization must learn to do well.

Delegating to senior management is the most difficult transition for an entrepreneur. Fear of losing control is the primary reason. Ironically, delegating to senior management is the only way to gain back control. Furthermore, it achieves an "hour glass" organization structure which provides the essential management expertise to get through No Man's Land.





TEST WHETHER YOU ARE IN NO MAN'S LAND -

- *Is your company outgrowing the abilities of certain long-term loyal staff?*
- *Is everybody waiting on you to do something?*
- *Are you the only "senior" management?*
- *Are you not allowing people the authority to make mistakes?*
- *Is your company confused with priorities and direction?*
- *Do you have too many meetings?*
- *Do you fear losing control to new management?*
- *Are there dotted lines in your organizational structure?*
- *Does your staff feel you attempt to implement your most recently read management theory?*

9

Raise Your Money

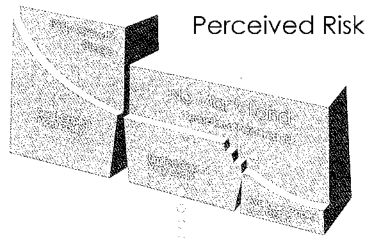
REDUCING PERCEIVED RISK

Most companies enter No Man's Land without enough capital to leave it. If and when they fail, "undercapitalization" becomes the blame. But undercapitalization is really not the cause. It is instead a fatal symptom of another cause: a company's inability to raise capital because it is perceived as too risky; or in our words, it is perceived as unable to escape No Man's Land.

While a company may have tremendous upside potential, in order to raise money it must focus on reducing its perceived risk; or in other words, it must prove that it can indeed escape No Man's Land. However, proving this to the appropriate capital sources is impossible unless a company takes certain real steps related to:

- ***understanding its MODEL;***
- ***realigning with its MARKET; and***
- ***hiring senior MANAGEMENT.***

Once specific steps are taken, the perceived risk is lowered and capital becomes available to the company.



TEST WHETHER YOU ARE IN NO MAN'S LAND -

- *Are you experiencing poor cash flow?*
- *Have you been repeatedly turned down by banks and others for financing?*
- *Are you unable to make needed capital investments?*
- *Are you unable to hire key people because they view the business as too risky?*
- *Are you unable to recruit key people because you cannot afford to pay them?*

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NO MAN'S LAND

Where Growing Companies Fail

SUMMARY

The growth that leads a company into No Man's Land will not lead a company out of it. Successful passage requires entrepreneurs to step away from day-to-day operations and honestly evaluate themselves and their companies in light of the "4 M's of Growth" outlined in this booklet. Only then can an entrepreneur begin redirecting corporate energies to transition the company to the success that lies beyond.

Our firm salutes the tough and creative resourcefulness of those men and women we have worked with over the years who have enjoyed successful passage through No Man's Land. We at Tatum CFO sincerely hope that the principles set forth in this booklet will assist other entrepreneurs in exiting No Man's Land and ultimately realizing their own corporate visions.

The Road To Success

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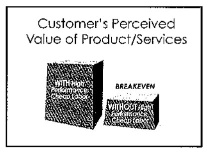
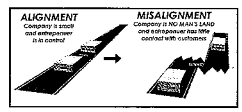
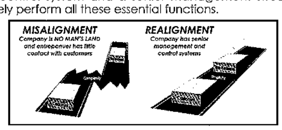
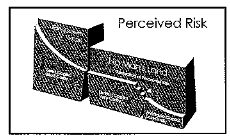
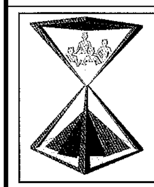
NO MAN'S LAND

<table>
<tr><th></th><th>THE MODEL</th><th>THE MARKET</th></tr>
<tr><td>Core Issue</td><td>A business model quantifies a company's true economic potential for growth as well as the required resources for such growth. Market forces, management decisions and changes in performance will dramatically alter a company's original business model as it grows.</td><td>A company's products, services and operations must be aligned with its market at all times. When a company is small, the entrepreneur ensures alignment. As it grows, the demands on the entrepreneur are such that the entrepreneur can no longer ensure alignment.</td></tr>
<tr><td>Key Illustrations</td><td>Most companies are built during their formative stages on high performance, cheap labor. Essentially, the entrepreneur and a core group of loyal employees work harder to provide superior service. However, the unrelenting economic reality is that eventually normal wages must be paid for average performance.
This is merely one example of a market force that will fundamentally change a company's business model as it grows.

</td><td>Growth invariably drags an entrepreneur into many of the day-to-day issues related to operations, accounting, finance and personnel. The result is that the entrepreneur loses touch with the customer and the market.

Without the entrepreneur performing the role of personally processing the changing needs of the customer and ensuring alignment, the company drifts into misalignment. The litmus test of alignment is that the relationship between the customer and the business can be characterized as simple in all respects.

</td></tr>
<tr><td>Key Transition</td><td>A company must first understand its current business model and then discipline itself to continuously quantify the impact of on-going changes to the model that result from -
1) market forces;
2) company performance; and
3) management decisions.</td><td>When misalignment occurs, realignment must begin. This requires the entrepreneur to extricate himself or herself from the day-to-day and gain an objective perspective of the business once again. Gaining an understanding of the company's business model is also crucial to this process.
</td></tr>
<tr><td>Questions to Consider</td><td>How long has it been since you have modeled in great detail the financial parameters of your business? Have you made any key decisions lately without the confidence of knowing its financial impact?</td><td>Do you have the same perspective of your business and its market as you did when it was much smaller? Would you say that simplicity describes the relationship between your customer and your company?</td></tr>
<tr><td>14 Key Principle</td><td>Understand your MODEL.</td><td>Realign with your MARKET.</td></tr>
</table>

A Summary of the 4 M's of Growth

THE MANAGEMENT	THE MONEY
Once a company recognizes it is misaligned, the process of realignment and maintaining alignment cannot be performed by the entrepreneur any longer. This is also true of certain specific skills that have been performed by the entrepreneur often since the company's inception.	A company in No Man's Land typically does not have enough capital to exit No Man's land.
An entrepreneur acting as the sole senior manager of a company is responsible for maintaining alignment, managing operations, and raising capital, while also performing his or her unique skill set. When a company is small, these demands are both less in number and relatively simpler. As a result, they can be performed and managed, often by intuition, effectively. Growth, however, exponentiates the issues for management to assimilate and address. Only a control system and a senior management structure can effectively perform all these essential functions. 	In No Man's Land, the entrepreneur will attempt to obtain financing from various sources. Given the company's success to date, the entrepreneur becomes discouraged when efforts prove unsuccessful. However, the problem is not because the company does not represent a promising upside. Rather, the company is perceived as too risky. Therefore, if the perceived risks can be reduced, affordable capital becomes available. 
 To gain back and maintain alignment, the entrepreneur must hire and delegate to senior management the responsibility of implementing and managing a control system. Certain specific skills of the entrepreneur must also be delegated so the company can acquire these same skills.	To successfully obtain needed capital, the company must reduce its perceived risk to capital sources. This is accomplished when it takes certain real steps to - 1) understand its Model; 2) realign with its Market; and 3) hire its senior Management.
Have you designed your company's internal operations to run efficiently, but at the expense of losing a relationship with your customers that is simple? Do you give your senior management enough authority to make mistakes?	What steps can be taken in these three areas to reduce your perceived risk ?
Hire senior MANAGEMENT and let them manage.	***Take real steps to reduce your perceived risk so you can raise needed MONEY.*** 15

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