MARYLAND
Department of Business & Economic Development

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State Small Business Credit Initiative Act of 2010

Small Business Lending Fund Act

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Testimony before the
House Committee on Financial Services

May 18, 2010

Introduction

Chairman Frank and Ranking member Bachus, and distinguished members of the Financial Services Committee, good afternoon. My name is Christian Johansson and I am the Secretary of the Maryland Department of Business & Economic Development. On behalf of Governor Martin O'Malley, I appreciate the invitation to bring my perspective on small business access to credit and support the provisions contained in the State Small Business Credit Initiative Act of 2010.

As all of us are painfully aware, as the American economy is recovering from this global recession, one of the lingering challenges continues to be access to credit, especially for our small businesses. Last week, the Congressional Oversight Panel released its May report stating that "if the Troubled Asset Relief Program (TARP) is to meet its Congressional mandate to promote growth and create jobs, then it clearly must address the needs of small businesses."

Small businesses have long been an engine of economic growth and job creation in America. More than 99% of American businesses employ 500 or fewer employees and together, these companies employ half of the private workforce. Maryland is home to 156,000 businesses with fewer than 100 employees, or 98% of all our businesses.

In the aftermath of Wall Street excesses, banks have been forced to adopt significantly stricter banking practices, which have reduced the flow of credit to their Main Street clients. In Maryland, Governor O'Malley recognized that it is not sufficient to address to only address Wall Street's credit crisis, but equally important, we must also address the credit tsunami affecting Main Street. As Wall Street Banks repay the federal government on time and with interest, we have a unique moment in history to continue our recovery further and faster – taking advantage of a nationwide network of loan guarantee programs and extending a very specific, safe and successful practice to main street lending – helping stabilize and expand small businesses to recapitalize, regain revenue, hire new employees, purchase or renovate property, acquire needed equipment and return to economic prosperity.

Maryland Takes a Leadership Role

This past February, Governor Martin O'Malley outlined a bold but simple proposal to his colleagues at the 2009 annual meeting of the National Governor's Association: Re-use a percentage of the TARP repayment funds to support state loan guaranty programs. A loan guaranty program would give banks the additional "push" to allow them to make loans to credit worthy businesses that are short on collateral. In less than 24 hours, 28 States and US Territories joined the Governor and signed a bi-partisan letter to President Barack Obama urging the Administration to work with the Congress to extend a partial payment of the TARP funds using existing loan guaranty programs. The letter demonstrated the bipartisan support for an initiative that can get Main Street businesses moving forward again. Getting capital to small business is critical to sustaining the country's recovery and continued job growth. Access to capital is key to America's sustained economic recovery.

We strongly urge favorable consideration of the State Small Business Credit Initiative Act of 2010 and support consideration for funding to be made available to state small business guaranty and loan programs. Many state programs are already in place and can have an immediate impact – putting operating capital into the hands of business owners in order to hire full and part time employees, restock their shelves and expand operating hours. These programs are "shovel ready." Unfortunately, given fiscal constraints at the state level, these programs are for the most part woefully under-capitalized.

Maryland is well poised to speak to best practices of model programs that unfreeze credit for the nation's small businesses and manufacturers and encourage small and medium sized banks to increase lending to small businesses. As Maryland's economic development (and jobs) chief - I am honored to join you today and explain how this "Main Street" approach has worked to strengthen small businesses in Maryland, and how banks and businesses have used the program model successfully, and why this is an effective federal investment.

Background & Rationale

Small Business Credit Crunch & New Stricter Lending Guidelines

Despite signs of an economic turnaround, small businesses continue to struggle with access to capital due to overall more conservative banking practices. Credit conditions are particularly troublesome for small businesses because their finances are more closely intertwined with the personal finances and assets of their owners. As a result, many businesses are reluctant to make new investments until they are confident that a recovery in sales can be sustained.

As you know, the Congressional Oversight Panel just released its report on the small business credit crunch showing that small business credit remains severely constricted. It cites data from the Federal Reserve that shows lending plummeted during the 2008 financial crisis and remained sharply restricted throughout 2009. Between 2008 and 2009, the small business loan portfolios of Wall Street banks **fell by 9%**, more than double the 4.1% decline in their entire lending portfolios. During this time period the smallest banks small business lending portfolios fell by almost 3%, while their entire lending portfolios fell 0.2 percent.

While steps were taken to insure that community banks have sufficient capital to lend, it is also important to recognize that even fully capitalized, many of these banks still did not extend credit to small businesses. Right now, given the impact of the recession on businesses and "new" stricter lending criteria, many previously credit worthy small business customers no longer qualify for a loan or a line of credit.

Devalued Equity

The recession's lingering impact and the greatest challenge that remains has been the devaluation of assets of individuals, homeowners and business owners. As far too many Americans have lost value in their homes and are "upside down" on their mortgages, far too many businesses have also lost value in their assets. Their lines of credit have been exhausted, not because their businesses are unsuccessful or unstable but because the value of real estate, durable goods and equipment has dropped precipitously. Along with the devaluation, America's banking crisis resulted in new, stricter lending criteria. Previously credit-worthy lending customers were no longer able to qualify for loans or lines of credit.

In essence, the convergence of stricter lending standards with collateral shortfall created a perfect storm to shut out small businesses from our economic recovery plan.

<u>Loan Guarantee Programs Work - America Has a "Shovel Ready" Opportunity</u>

We believe that guaranty programs can directly address the issue of otherwise credit worthy businesses not receiving access to credit by lowering the perceived credit risk through small guaranties that cover any perceived collateral shortfall. In this way, state guaranty programs facilitate small business lending by community banks – a marriage of the two legislative proposals that are before us today.

While it is difficult for individual states or territories to directly lend to small businesses on a large scale, it is possible to unlock multiple dollars of private bank lending and unleash additional funding for business owners through loan guaranty programs. The State Small Business Credit Initiative Act, H.R. 5302, offers sufficient flexibility for each state to use these existing, often more nimble, grassroots programs and to determine, based on their own circumstances, how to have the quickest and most meaningful impact. According to the Council of Development Finance Agencies, 34 states have some form of existing loan guaranty program. However, in today's economic environment, many of these programs are challenged in terms of available funding. That is why the State Small Business Credit Initiative Act is necessary.

Successful State Examples

- In Massachusetts, the state's Small Business Capital Access Program (CAP) uses cash collateral guaranties from a loan loss reserve fund to enable banks to make loans they might otherwise be unable to grant. The program was created by the Massachusetts Business Development Corporation (MBDC) in 1993 and over the past 17 years, CAP has been one of the most successful economic development tools in Massachusetts, making 4,285 loans to community-based, small businesses.

- The Indiana Loan Guaranty Program provides loan guarantees for rural development and value-added agricultural projects and for high-growth/highskilled companies and manufacturing projects. The program has funded more than 83 loans providing over $84 million in guaranteed loans to Indiana businesses.

- The New Jersey Economic Development Authority (EDA) provides loan guarantees to creditworthy businesses operating in New Jersey that need additional security to obtain financing, up to 50% of the loan amount up to $1.5 million. To be eligible, companies must create one job for every $50,000 of EDA assistance. Funding can be used for fixed assets and working capital to meet operating needs, with term financing for a maximum guarantee term of five years.

Based on the leverage ratio of ten-to-one in the State Small Business Credit Initiative Act, $3 billion in funding invested into states' loan guaranty programs could unlock as much as $30 billion in small business lending. The funding of a guaranty program is more effective than direct lending since the investment can be leveraged multiple times as a guaranty, the cash is only expended in the event of a default deficiency, and guaranties leverage multiples of bank loan dollars. Strengthening state guaranty programs would also serve as an important complement to the on-going efforts to support small businesses through a variety of programs at the Small Business Administration (SBA).

The Maryland Model

Maryland Industrial Development Financing Authority

The Maryland Industrial Development Financing Authority (MIDFA) was established in 1965 as the State's principal credit enhancement program to increase access to capital for small and mid-sized companies. MIDFA stimulates bank loans and bonds by providing a credit deficiency guaranty that reduces credit risk and facilitates better terms. In the past 45 years, MIDFA has participated in 823 loans and bonds totaling over $2.1 billion. Currently, 58 transactions remain active with principal balances totaling $427 million. Early signs of economic recovery coupled with aggressive program marketing resulted in a burgeoning interest from banks and borrowers. Over the last five years, the program has not experienced any loan deficiency losses.

Recently Modified to Address Small Business Loans

Because of its statutory guaranty maximums of $2.5 million for loans and $7.5 million for bonds, MIDFA typically has been used for larger transactions.

However, to address the current credit crisis, MIDFA implemented two streamlined capabilities, referred to collectively as our "Rapid Response Program," that expedite small business lending by providing approvals in 48 hours or less for: (a) a 50% guaranty up to $50,000 for loans not exceeding $100,000, and (b) a 25% guaranty up to $250,000 for loans not exceeding $1,000,000.

This enhancement of MIDFA was developed after significant outreach with regional and community banks as to what programs they perceived had the highest value in stimulating small business lending. Since Governor O'Malley announced this new program earlier this year, the State has committed $10 million to guaranty small business loans and has already unlocked in excess of $5 million of small business lending. More than $3 million was used to expand certified minority business enterprises. This is especially important because many of the banks that do not have relationships with the SBA are community banks, many of whom are owned by and do business with small and minority businesses.

For example, Kayden Premier Enterprises and Harbor Bank of Maryland are two Maryland companies who have benefited from MIDFA since the State modified the program. Kayden experienced significant growth over the past three years. The company grew from approximately $42,000 in revenues in 2007 to projected $4.5 million in the first six months of this year. The company needed a line of credit to support its cash flow due to its growing pipeline of projects including a large contract with Clark/Bank, a construction company joint venture. Harbor Bank was willing to provide the line of credit contingent upon receiving some type of credit enhancement to support its collateral position due to the inherent risk in the construction industry and the relatively young age of the company. MIDFA provided $50,000 insurance (50%) on the $100,000 line of credit, making it possible for Kayden to receive the financing needed to support its growth while doing so under an acceptable risk profile for Harbor Bank.

Very Effective in Leveraging Federal Dollars

MIDFA's small business guaranty can unlock a minimum of $10 of private sector lending for every $1 of federal funds injected into the program. This would yield an average 10+:1 loan to fund ratio. This number would easily exceed 10: 1 if the guaranty funds are allowed to revolve in the MIDFA program rather than being subject to repayment.

Conclusion

Mr. Chairman, Mr. Ranking Member, and members of the Committee, there are many opportunities for states - in cooperation with regional banks, community banks and regional revolving loan funds, and the SBA - to assist small businesses. We strongly urge Members to swiftly pass the State Small Business Credit Initiative Act of 2010 and to make funding available to state small business guaranty and loan programs. While it is critical to recapitalize our community banks, it is also important to complement this with appropriately capitalized loan guaranty programs – which is a "shovel-ready" asset waiting to be unlocked on a larger scale.

There is no silver bullet to solving the lingering effects of a prolonged economic recession. As part of your efforts to spur small business lending – and on behalf of Maryland Governor Martin O'Malley - we urge you to consider loan guaranty programs such as MIDFA.

Thank you for your time and consideration.