Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

Memorandum

To:	Members, Committee on Small Business
From:	Sam Graves, Chairman
Date:	May 31, 2011
Subject:	Full Committee Hearing: "Access to Capital: Can Small Businesses Access The Credit Necessary To Grow and Create Jobs?"

Introduction

On Wednesday June 1, 2011 at 1:00 pm the Committee on Small Business will conduct a hearing titled, *"Access to Capital: Can Small Businesses Access The Credit Necessary To Grow and Create Jobs?"* The hearing will provide a forum for lenders and business owners to discuss the current economic environment and how they are working to support private sector job growth. Witnesses from the lending side will discuss the demand for capital, credit standards and current initiatives to encourage small business lending. Small business owners will testify about the current economic environment and decision process for deciding to take on additional capital and hire new employees.

Current Economic Environment

A small business typically seeks capital when they are new, or seeking to expand an existing business. In April, the National Federation of Independent Business Optimism Index that measures business owner confidence fell for the second straight month, with business owners citing concerns over inflation, energy costs and negative feelings about the overall economic outlook.[1] Due to this uncertainty about the economy, some small business owners are reluctant to take on additional capital, when they do not know if they will have either the customers or the sales to support growth.[2] Despite the reluctance to take on additional, for those seeking to expand or hire new employees, some business owners are finding it difficult to overcome the new requirements that lenders have established in the wake of the financial crisis.

The first quarter of 2011 marked the best first quarter for the stock market since 1998. Despite the gains by Wall Street, many small businesses continue to have trouble accessing the capital they need to expand.[3] One of the issues impacting small business access to capital is that banks, as a result of the credit crunch, have tightened their lending standards for small firms. According to a speech by Federal Reserve Chairman Ben Bernanke, credit-worthy small businesses are having trouble getting loans.[4] The Federal Reserve Board's Senior Loan Officer Survey has reflected tighter commercial and industrial lending standards since 2007 and weaker demand for lending overall.[5] Further, the Small Business Administration (SBA) Office of Advocacy found that: *"Small business lending peaked in 2008, when depository institutions in the United States held small business loans valued at more than $711 billion. From 2008 to 2010, small business lending by depository institutions declined by 8.3 percent to $652 billion."*[6] [7]

If small businesses cannot access capital, they have difficulty retaining employees in tough times and hiring new workers when conditions improve. According to SBA's Office of Advocacy in the first three quarters of 2009, small businesses accounted for nearly 60 percent of the net job losses.[8] [9] While small businesses shed a majority of the jobs during the financial crisis, they will also be the driver of job creation as America continues to recover. Small Businesses have historically created 64 percent of all new jobs over the past 15 years.[10]

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[1] Luca DiLeo and Jeff Bater, and Kathleen Madigan, *Import Prices Tick Up As Commodities Soar,* Wall Street Journal (May 11, 2011at A3.

[2] Dennis Jacobe, Chief Economist, *U.S. Consumer Spending Down Sharply in Early January,* Gallup, (Jan. 13, 2011).

[3] U.S. Chamber of Commerce, *Small Business Access to Capital: Critical for Economic Recovery* (July 2010).

[4] Scott Lanman & Ian Katz, *Bernanke Says 'Creditworthy Small Business Can't Get Loans*, Bloomberg, (July 12, 2010).

[5] Chad Moutray, *International Franchise Association: Small Business Lending Summit White Paper Presentation*, Moutray, Chad. (April 2011).

[6] SBA Office of Advocacy, *"Small Business Research Summary: Lending by Depository Lenders to Small Businesses 2003 to 2010,* (March 2011).

[7] SBA Office of Advocacy data is based on Federal Deposit Insurance Corporation (FDIC) Call Report data which measures small loans, but not lending to small business. Therefore true data on lending to small business might be over or under reported since a small business could receive a large loan, or a large business could receive a small loan.

[8] SBA Office of Advocacy: *Small Business Research Summary* January 2011.

[9] According to the SBA Office of Advocacy, net job change is the numbers of jobs gained minus the number of jobs lost. When the figure is negative, Advocacy refers to it as a net job loss.

[10] SBA Office of Advocacy, *Small Business Economy Frequently Asked Questions* (January 2011).

Banks, in the business of making loans, may have financing available, but claim that it is harder to find small businesses interested in taking on an additional financial burden. Prior to the financial downturn, both banks and business owners were willing to take advantage of low cost financing. However, now that credit has tightened, banks are more risk adverse and have returned to requiring greater collateral and documentation in an attempt to prevent potential losses should a business not be able to repay their loan. Because of the costs associated with underwriting and servicing loans and default, it is in the interest of both the bank and the business that standards remain in place to provide appropriate safeguards for both parties not to over-extend themselves.[11]

Small Business Financing

Debt Financing

Debt financing involves the issuance of funds in return for the promise to pay those funds back with some set or fluctuating rate of interest.[12] Typically, lenders will assess small businesses on five factors before making a loan (called the five C's): character, capacity, capital, collateral, and conditions.[13] Character generally involves an assessment of the borrower's reputation, honesty, integrity, responsibility, and consistency.[14] Capacity refers to the ability of the business owner to pay back the loan and this generally depends on the cashflow and earnings of the business.[15] Capital involves the amount of equity that the business owner has invested in the business (the more equity, the more likely that the borrower will repay the loan).[16] A lender is more likely to issue a loan if the collateral can be sold for nearly the amount of the loan.[17] Conditions refer to the overall state of the economy or the state of a particular industry.[18] These elements are not only used to assess the likelihood of repayment but also the interest rate that should be charged with greater risk (lower probability of repayment).[19]

Loans to support small business financing generally can be broken down into several categories:

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[11] Appropriate safeguards might include documentation requirements, income verification and cash flow analysis among other requirements.

[12] Loans are available from a wide variety of sources including: family members or friends, banks, credit unions and non-bank commercial financial institutions. In addition, loans may be backed with federal guarantees from the U.S, Small Business Administration or the U.S. Department of Agriculture.

[13] R. HISRICH, M. PETERS & D. SHEPHERD, ENTREPRENEURSHIP, at 352.

[14] B. GUP & J. KOLARI, COMMERCIAL BANKING: THE MANAGEMENT OF RISK, at 263.

[15] *Id.* at 263-64.

[16] *Id.* at 264.

[17] *Id.*

[18] *Id.* While a business may have excellent earnings and cash flow, conditions affect assessment of the future capacity for the small business to repay the loan.

[19] *Id.* at 265-72.

- Lines of credit enable a borrower to obtain money from a lender up to a predetermined amount, last less than a year, and are used to fund operations until revenue is received through the sale of the businesses goods or services.[20]
- Term loans are issued in a set amount for a single purpose (but generally not to provide working capital for day-to-day business operations) and generally have maturities of five years or more.[21]
- Bridge loans are used to cover gaps in financing to cover a specified event and typically have short maturities, but not always.[22] When a financial institution makes an asset-based loan, the collateral is typically the asset being purchased and such loans may be short- or long-term depending on the type of asset being purchased.[23]
- Finally, some businesses will lease tangible assets, enabling them to utilize the asset without completely taking ownership of the asset.[24]

Equity Financing

Besides going to a bank for a loan, small businesses, particularly ones with high growth potential, might have access to equity financing. Equity financing is a funding source where investors purchase an ownership stake in a company, allowing the investor access to a percentage of future profits.[25] A benefit of equity financing, over debt financing, is that it allows a business to obtain funds without having to repay a specific amount of money at a particular time.[26] There are several different types of equity financing available including: private equity, venture capital and angel investors. The difference between these investors varies depending on the stage where the investor becomes involved and the size of the management group responsible for the fund.[27]

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[20] B. GUP & J. KOLARI, COMMERCIAL BANKING: THE MANAGEMENT OF RISK 257 (3d ed. 2005). Revolving loans are similar to lines of credit but generally last longer than a year. *Id.* at 258.

[21] *Id.*

[22] For example, a small business may need temporary debt capital while it waits for the finalization of an initial public offering. A bank will make the loan to bridge the gap until the initial public offering is complete. *Id.*

[23] *Id.* at 258-59. For example, a small business that purchases a machine tool may take out a loan with a long maturity. On the other hand, an appliance store that borrows money to purchase refrigerators for sale to consumers (so-called floor plan financing) may have very short maturities based on the quick resale of the inventory. In many instances, the lender will take a security interest in the collateral purchased using Article 9 of the Uniform Commercial Code. *See* C. BAGLEY & C. DAUCHY, THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW 390-99 (3d ed. 2008).

[24] B. GUP & J. KOLARI, COMMERCIAL BANKING: THE MANAGEMENT OF RISK, at 260. The most common example might be a realtor that leases a vehicle and makes lease payments to an automobile finance company that retains title to the vehicle. Leases can be extended to many durable assets including railroad cars, ships, planes, and even buildings. *Id.*

[25] Some equity investors including family and friends might not be as concerned about growth as are investors with no prior connection to the business.

[26] CRS Report R41456, *SBA Small Business Investment Company Program* by Robert Jay Dilger & Oscar R. Gonzales..

[27] Venture capital investors are more likely to become involved with a small business during the early stage of product development, whereas angel investors are usually high net worth individuals or small groups as opposed to management teams with multiple investors.

As a result of the economic crisis, equity financing has also slowed. Some estimates show there is up to $500 billion in pent-up investment dollars in the economy.[28] The goal of many equity investors is to recover their initial investment through initial public offerings (IPOs). However, in recent years, the cost of taking a company public has increased, and IPOs have been on the decline. According to the National Venture Capital Association, in 2010, there were 32 Venture backed IPOs of over $100 million, this is down from 239 in 2000.[29]

SBA Capital Access Program Overview

To support small business, the government acting through the SBA offers several programs designed to help small businesses access credit.[30] These programs provide access to both debt and equity financing. Below is a brief summary of SBA's capital access programs:

7(a) Loan Program. The 7(a) Loan Program provides financial help for small businesses that cannot obtain credit elsewhere. In this program, a commercial lender provides financing to the small business. The government guarantees a percentage (up to 90 percent) of a loan from a participating lender in case of default by the borrower.

504/CDC Loan Guarantee Program (504 Program). This program provides long-term, fixed-rate financing for major fixed assets (land, equipment, machinery). A commercial lender covers 50 percent of a project cost which is secured by a senior lien. Certified Development Companies (CDCs), which are private, nonprofit corporations, finance 40 percent of the cost that is secured by a junior lien. The CDC's share is 100 percent guaranteed by SBA. The final 10 percent of the project or equipment cost comes from the borrower.

Small Business Investment Company (SBIC) Program. This program is a public-private partnership created to stimulate the flow of private equity capital to small businesses. After raising sufficient private capital ($5 million) and having their business plans approved by SBA, funds utilize an SBA-guaranteed instrument sold into the commercial market. Funds "leverage" the government guaranteed debenture to provide additional capital to small businesses. The SBIC repays the federal government out of the proceeds from the investments it makes. To mitigate potential losses, SBA imposes a dollar limit on the size of funds and the amount of leverage.

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[28] Eddy Goldberg, *Is Private Equity Right for You?* Multi-Unit Franchise Issue II, 2011, at 56,.
[29] Kate Mitchell, Chairman, National Venture Capital Association Presentation to the Department of Treasury Access to Capital Conference (March 22, 2011).
[30] Small Business Jobs Act of 1958 15 U.S.C. § 631 *et. seq.*

Recovery Act / Stimulus

To meet the need for capital resulting from the economic crisis, the SBA and the U.S. Department of the Treasury have exercised unprecedented government intervention into the small business economy through the American Recovery and Reinvestment Act (ARRA) and the Small Business Jobs Act of 2010. The small business provisions in both laws made several programmatic changes and created several programs intended to get money into the hands of small businesses and provide a host of temporary inducements to encourage banks to lend. Notable programs include:[31] [32]

American Recovery and Reinvestment Act

- $730 million provided to SBA to temporarily reduce fees and increase the government guarantee for SBA's 7(a) loan program to 90 percent;
- established a temporary secondary market guarantee authority to provide a federal guarantee for pools of first lien 504/CDC program loans that are sold to investors;
- authorized SBA to use emergency rulemaking authority to make below-market-interest-rate direct loans to "Systemically Important Secondary Market Broker-Dealers;"
- $255 million for SBA to establish a temporary American's Recovery Capital Loan program
- $15 million for SBA's surety bond program, and increased the maximum bond amount to $5 million from $2 million;
- $6 million for SBA's Microloan Program;
- $24 million for SBA's Microloan technical assistance; and
- increased the leverage available for SBA's SBIC program.

Small Business Jobs Act of 2010:

- extended SBA's secondary market guarantee authority;
- $22.5 million to SBA for a temporary Small Business Intermediary Lending Pilot Program to provide direct loans to intermediaries that provide loans to startups, newly established small businesses and growing small businesses;
- $15 million in additional funding for SBA's 7(a) program;
- increased the maximum loan amount to $5 million from $2 million for SBA's loan guarantee program;
- increased the maximum project amount to $5 million from $1.5 million for SBA's 504/CDC program for regular borrowers, to $5 million from $2 million if loan proceeds

[31] Pub. L. No.111-5 (2009) see CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger & Oscar R. Gonzales..
[32] Pub. L. No. 111-240 (2010) see CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger & Oscar R. Gonzales.

are directed towards a specified public policy goal and to $5.5 million from $4 million for manufacturers;

- temporarily increased the SBA 7(a) Express program limit to $1 million from $350,000;
- established an online lending platform; and
- established a temporary refinancing program in the 504/CDC program.

U.S. Department of the Treasury Small Business Program Overview

Small Business Lending Fund (SBLF)

Created by the Small Business Jobs Act of 2010, the SBLF is a $30 billion dollar fund at the Department of the Treasury that allows the government to purchase preferred stock in small-and medium-sized banks.[33] Dividend payments are lowered contingent on the percentage that the recipient increases their small business lending. Eligible financial institutions include those with under $10 billion in assets.[34] [35] The interest rate that financial institutions must pay to Treasury begins at 5 percent.[36] The dividend or interest rate decreases if the lending to small business increases by the following amount:[37]

Increase in Lending	Dividend or Interest Rate
Less than 2.5 %	5 %
2.5 % to 5 %	4 %
5 % to 7.5 %	3 %
7.5 % to 10 %	2 %
Greater than 10 %	1 %

The percentage of increase is determined by a baseline lending amount that is established during the application process through a review of the institution's Call Report Data for the year prior to application to the SBLF program. The institution must also provide Treasury with a plan detailing how they intend to address small business lending needs in their community.[38]

State Small Business Credit Initiative (SSBCI)

This initiative is a $1.5 billion grant program that provides money to States to fund state economic development programs. States choosing to participate in this program must partner with private lenders to extend credit to small businesses. For every $1 in federal funding, states

[33] Press Release, White House, *President Obama Outlines New Small Business Lending Fund,* (Feb. 2, 2010).
[34] Pub. L. No. 111-240 (2010) § 4103(a)(2).
[35] Id. § 4103(d).
[36] Id. § 4103(d)(5).
[37] Id. § 4103(d)(5).
[38] P.L. 111-240 § 111-240(d)(1)(E).

must demonstrate that they will be able to leverage $10 in new private lending.[39] Accordingly, Treasury anticipates that this initiative will spur up to $15 billion in lending to small businesses.[40]

State	State Small Business Credit Initiative Allocation	State	State Small Business Credit Initiative Allocation	State	State Small Business Credit Initiative Allocation
Alabama	$31,301,498	Alaska	$13,168,350	Arizona	$18,204,217
Arkansas	$13,168,350	American Samoa	$13,168,350	California	$168,623,821
Colorado	$17,233,489	Connecticut	$13,301,126	Delaware	$13,168,350
District of Columbia	$13,168,350	Florida	$97,662,349	Georgia	$47,808,507
Guam	$13,168,350	Hawaii	$13,168,350	Idaho	$13,168,350
Illinois	$78,365,264	Indiana	$34,339,074	Iowa	$13,168,350
Kansas	$13,168,350	Kentucky	$15,487,998	Louisiana	$13,168,350
Maine	$13,168,350	Maryland	$23,025,709	Massachusetts	$22,032,072
Michigan	$79,157,742	Minnesota	$15,463,182	Mississippi	$13,168,350
Missouri	$26,930,294	Northern Marianas	$13,168,350	Montana	$13,168,350
Nebraska	$13,168,350	Nevada	$13,803,176	New Hampshire	$13,168,350
New Jersey	$33,760,698	New Mexico	$13,168,350	New York	$55,351,534
North Carolina	$46,061,319	North Dakota	$13,168,350	Ohio	$55,138,373
Oklahoma	$13,168,350	Oregon	$16,516,197	Pennsylvania	$29,241,232
Puerto Rico	$14,540,057	Rhode Island	$13,168,350	South Carolina	$17,990,415
South Dakota	$13,168,350	Tennessee	$29,672,070	Texas	$46,553,879
Utah	$13,168,350	Vermont	$13,168,350	Virginia	$17,953,191
US Virgin Islands	$13,168,350	Washington	$19,722,515	West Virginia	$13,168,350
Wisconsin	$22,363,554	Wyoming	$13,168,350		

[39] U.S. Department of the Treasury, *Treasury Announces State-by-State Funding Allocations to Support $15 Billion in Small Business Lending, Create New Jobs* (Oct. 8, 2010).
[40] U.S. Department of the Treasury. http://www.treasury.gov/resource-center/sb-programs/Pages/ssbci.aspx.

Questions for Further Examination

The hearing seeks to examine the state of the small business economy from the perspective of both the small business owner who may be looking for capital and the commercial lenders looking to finance small businesses. Members will have the opportunity to ask witnesses about what is needed create jobs and grow our economy. Further, Members will be able to ask about federal policies and regulations that help or hinder small business access to capital.