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"Small Business Financing: Progress Report on Recovery Act Implementation and Alternative Sources of Financing"

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Madam Chair, Ranking Member Snowe, and members of the Committee, good afternoon. Senator Pryor and Senator Wicker, it is good to see you again. Thank you for holding this hearing on the role of small business development in the nation's economic recovery and for inviting me to testify.

I serve as Chief Executive Officer of the Enterprise Corporation of the Delta (www.ecd.org) and Hope Community Credit Union (www.hopecu.org) (ECD/HOPE). ECD/HOPE works to strengthen communities, build assets and improve lives in economically distressed areas in Arkansas, Louisiana, Mississippi and Tennessee. We accomplish this by providing affordable financing and related services both directly and in collaboration with nonprofit organizations, banks, public agencies, charitable foundations and others; and by conducting analysis of polices that affect the development of low-wealth people and communities. ECD/HOPE's efforts have benefited more than 70,000 individuals in the Delta, Katrina-affected areas and other distressed communities throughout the Mid South, and generated over $1 billion in financing for entrepreneurs, homebuyers and community development projects.

In my testimony today, I will focus on three key points:

I. The challenges facing small business development efforts in underserved markets.
II. The role of non-bank lenders in addressing the capital gap in the current environment.
III. Public policy options to promote small business development.

I. Challenges Facing Small Business Development Efforts in Underserved Markets

In 2006, over 99% of the country's firms were small companies that employed fewer than 500 people. Those firms provided more than 60 million jobs and over $2.1 billion in payroll that flowed into communities to support local economies.[1] Given the prevalence of small businesses in every state, the facilitation of small business development offers an important opportunity to strengthen and support the nation's economic recovery efforts.

One of the key hurdles faced by entrepreneurs and small business owners is access to capital. The April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices, conducted by the Federal Reserve Board, reported that 40% of domestic respondents tightened their credit criteria for small firms for commercial and industrial loans during the first quarter. The survey was the 10th quarterly survey in a row where a tightening was reported for small firms seeking to access credit. Thirty percent (30%) of respondents also reported decreases in business credit card account limits, and 40% reported smaller commercial and industry credit lines.[2]

According to the National Small Business Association, over half of small businesses reported difficulties accessing credit in 2008. The challenges are most pronounced in very small firms with four or fewer employees: 35% of these firms are unable to access the credit needed to operate. Of all small businesses surveyed with some type of financing, credit cards were the most frequently cited source of capital.[3]

In any discussion of capital access for small businesses, it is important to call attention to the historic and ongoing challenges of capital access for minority- and women-owned businesses and businesses located in distressed communities. The Community Development Financial Institutions Fund of the U.S. Treasury "has determined that there is strong basis of evidence that the following groups lack access to loans, equity investments and/or financial services on a national level: Blacks or African Americans, Native Americans or American Indians, and Hispanics or Latinos [and] Alaskan Natives residing in Alaska, Native Hawaiians residing in Hawaii, and Other Pacific Islanders residing in other Pacific Islands."[4]

Analysis of data from the Federal Financial Institution Examination Council show that only 22% of all loans reported that were made to businesses with sales of less than $1million in the Louisiana Delta were made to businesses located in low- and moderate-income areas.

Additionally, economic shocks felt by small businesses, unfortunately, do not affect all businesses equally. Following the 2005 hurricane season, research showed that credit was less accessible to African-American-owned businesses than it was to white-owned businesses in the Gulf Region. Related to the unequal access to credit, African-American-owned businesses closed at a rate that was 110% higher than businesses with white owners.[5]

II. The role of non-bank lenders in addressing the capital gap in the current environment

Community Development Financial Institutions (CDFIs) and Credit Unions play a critical role in bridging the capital gap in distressed communities. As of May 1, 2009, there were 842 certified CDFIs in the United States.[6] Data compiled through the CDFI data project revealed that in 2006, CDFIs financed 8,185 businesses that assisted 35,609 jobs. Importantly, CDFIs extended capital that created jobs in underserved communities in a responsible manner. The CDFI data project reported that 51% of CDFI customers are women, 58% are minority, and 70% are low-income. CDFIs reached these underserved populations and communities through responsible lending products. CDFIs in the same study "reported a net charge off rate of 0.46%." The charge off rate was only seven one hundredths of a percentage point higher than the charge off rate for banks insured by the Federal Deposit Insurance Corporation (FDIC).[7]

According to the Credit Union National Association, roughly 27% of the 8,147 credit unions in the U.S. offer business loans. The amount of business loans in 2008 was approximately $33 billion, with an average loan size of $215,000. Community Development Credit Unions (CDCUs) are an important subset of the credit union industry, and have a specific mission of providing financial services in disadvantaged communities, and therefore play a major role in revitalization efforts where traditional financial institutions are typically absent. The National Federation of Community Development Credit Unions reports a membership of 230 CDCUs that collectively serve more than one million members.[8]

The experience of ECD/HOPE has been similar to that of the CDFI industry as a whole. In 2008, 49% of ECD/HOPE's small business loans were made to minority- or women-owned businesses, and 50% of all small businesses financed were located in high-poverty communities. ECD/HOPE's rate of lending to businesses located in communities of economic distress was significantly higher than the average of 39.2% for banks located in Mid South metro areas. While providing capital to businesses located in low-income communities, ECD/HOPE maintained a strong portfolio, with charge offs in 2008 of only 1.4%.

As an example of our work, ECD/HOPE partnered with a local bank to finance First Class Linen, a dry cleaning and laundry service company that provides services to major institutions such as hospitals and hotels. Located in Durant, Mississippi, a town with a population of 2,932 and a poverty rate of 35.1%, First Class Linen provides jobs to 120 people. As a CDFI, ECD/HOPE used the federal New Markets Tax Credit program to provide the company with a $1.6 million loan at a 6% interest rate, with a seven-year interest-only period. In the absence of CDFI financing, the business would most likely not have found the funding needed to continue to operate, and 120 Durant jobs could have been lost.

Despite strong records of lending in distressed communities and a track record of sound fiscal management, CDFIs and CDCUs have not been immune to the challenges of increasing demand for credit accompanied by liquidity constraints. A recent quarterly survey of CDFI market conditions conducted by the Opportunity Finance Network – our industry trade association – found that 63% of its respondents reported an increase in financing applications. At the same time, 59% of respondents felt that they did not have enough capital to meet the growing demand for financing. Fifty-two percent (52%) projected that they also did not have enough operating grants to cover operations.

III. Policy Options to Promote Small Business Development

Given the importance of access to capital for a vibrant small business development sector – especially in distressed communities and among underserved populations – every effort should be made to leverage the expertise and track record of CDFIs and CDCUs. The following recommendations outline several opportunities for building on the successes of the community development finance industry.

Make Operating Lines of Credit Eligible for Guaranty under the SBA 7(a) Program

As mentioned earlier, lenders have recently reported smaller commercial lending credit lines. Small businesses depend on operating lines of credit to bridge timing differences between payment of expenses and collection of cash from sales or to compensate for seasonal sales swings. As operating lines of credit shrink, small businesses encounter challenges paying bills, which ultimately threatens their survival.

A policy option that could reverse the trend of shrinking operating lines of credit would be to make operating lines of credit eligible for guaranty under the SBA 7(a) program. The SBA currently does not have an operating line of credit product. It does have an asset-based line of credit; however, the product requires intensive monitoring by both lenders and borrowers of collateral and advance rates, and does not effectively allow businesses to manage cash flow in the manner described above. In order to mitigate long-term risk associated with using tax dollars to guarantee these types of loans, the program could sunset at the end of 2009 or 2010, similar to other provisions through the American Recovery and Reinvestment Act.

Modify the New Markets Tax Credits (NMTC) Program to Address Challenges that Discourage Revolving Small Business Loan Funds

Currently, New Markets Tax Credit Program requirements favor transactions that assist a large single company as opposed to revolving loan funds that can assist several small businesses. Using NMTC financing for single, large company transactions allows an applicant to easily demonstrate its ability to meet and maintain compliance with deployment requirements. On the other hand, applicants that use NMTC capital for revolving loan funds face greater difficulty with regard to deployment, as the recycling of funds must be carefully managed to maintain compliance with regulatory requirements. This discourages the use of the NMTC program for small business development. Also, because the NMTC scoring process places a high emphasis on deployment, these challenges can cause proposals for revolving loan pools to score lower and fail to receive NMTC awards.

Pine Bluff Iron Works in Pine Bluff, Arkansas, one of the first NMTC-supported loans made by ECD/HOPE, demonstrates the value of NMTC in supporting small businesses. Since 1902, Pine Bluff Iron Works (PBI) had been in the iron and steel welding business. In recent years, PBI provided services to regional railroad companies and many of the locks and dams along the Arkansas River. For the last 32 years, PBI enjoyed stable ownership and management. As the owner/manager approached retirement age, the future of the business was in question. Fortunately, PBI's owner had been grooming a new leader who saw the value of keeping a long-standing Delta-based business open and healthy. While a local bank was interested in working with the potential new owner to buy the business, the bank was not comfortable with the deal's risk rating. ECD used its expertise as a Small Business Administration (SBA) Lender to make the loan with a SBA guaranty, and the bank bought a 50% participation in the deal.

ECD used NMTC-backed capital to fund the loan to Pine Bluff Iron Works. The company repaid the loan, enabling ECD to use the revolved funds to make a subsequent loan to finance the growth of St. Mary CME Church's ministries in Bastrop, Louisiana.

By making it easier for applicants to use the NMTC program for revolving loan pools, this important U.S. Treasury Department program can be an important resource for small business development.

Model a National Small Business Recovery Program Based on Louisiana's Successful post-Hurricane Business Assistance Programs

Following Hurricanes Katrina and Rita in 2005, small businesses in Louisiana needed assistance to address sales interruptions and the costs associated with restarting and developing a business model that could succeed in a changed marketplace. In response, Louisiana structured several business assistance programs. One of the more successful initiatives was the Louisiana Small Business Loan and Grant program.

Through the Small Business Loan/Grant Program, Louisiana companies were eligible to receive loans with the following terms: no principal or interest payments for the first six months, followed by 0% interest for the next two years, and 4% for the remainder of the loan. In addition, up to 20% of the funding was provided as a grant to the business. The program offered small business owners a cushion that has enabled them to stabilize their operations, recoup some of their losses and retain key employees. To be eligible for the program, small businesses were required to demonstrate need and an ability to repay the loan based on historical performance.

The state used nonprofit intermediaries to deliver this program, with 779 companies receiving approximately $67 million in loans and grants. ECD/HOPE assisted 77 businesses, providing $7.7 million in funding.

By drawing on the Louisiana's experience in recovering from the nation's worst natural disaster, a national loan/grant program could be structured to provide low-cost capital to sustain small businesses during the current capital and credit crisis.

Provide Liquidity Support for Community Development Financial Institutions

CDFIs are an important and underutilized part of the nation's financial sector, and should be considered a primary resource in efforts to strengthen the economy, particularly in distressed areas. As such, the CDFI industry is very encouraged by the funding increase for the CDFI Fund recommended in the President's 2010 budget. However I would encourage that in addition to the emphasis that has been placed on the role of CDFIs in addressing housing and urban development issues, that similar <u>priority be given to supporting CDFIs that provide assistance to small businesses and to those that serve rural areas</u>.

<u>SBA should make CDFIs eligible for certification as SBA lenders</u>. As SBA lenders, CDFIs would substantially expand the use of SBA programs in underserved markets. In addition, this resource would provide additional liquidity for CDFIs through the sale of guarantees on the secondary market.

Finally, it is noteworthy that CDFIs are currently not eligible to participate in the Troubled Asset Relief Program. Earlier this year, information collected by a subcommittee of Treasury's Community Development Advisory Board estimated that the nation's 800 certified CDFIs could deploy over $3 billion in debt or equity capital over a two-year period. The advisory board recommended that the Administration <u>set aside $2 billion in TARP funds for use by CDFIs</u>. With access to TARP funds or another source of long-term, low-cost loans for capital deployment, CDFIs could direct substantial resources to small businesses in distressed areas.

In closing I would like to again thank this committee for your efforts to strengthen the nation's small businesses, and for the opportunity to testify before you today. As demonstrated by their successful track record, CDFIs, credit unions and other alternative financial institutions are uniquely positioned to help small businesses in distressed markets start, stabilize and expand their operations, and provide critical support for jobs in these areas. In light of the economic challenges facing our nation today, I encourage this committee to take every possible action to make full use of these proven but underutilized institutions, as we all work to assure a strong and equitable economic recovery that benefits all citizens.

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[1] *Data by State and Metropolitan Statistical Area (MSA) classified by employment size of firm*, U.S. Small Business Administration Office of Advocacy http://www.sba.gov/advo/research/st_06.pdf, accessed on May 6, 2009.

[2] *The April 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices*, Board of Governors of the Federal Reserve System http://www.federalreserve.gov/boarddocs/snloansurvey/200905/fullreport.pdf, prepared by John Driscoll and Seung Jung Lee with the assistance of Robert Kurtzman, accessed on May 6, 2009.

[3] *National Small Business Association 2008 Survey of Small and Mid Sized Businesses,* http://www.nsba.biz/docs/2008bizsurvey.pdf, accessed on May 6, 2009.

[4] *Federal Register*, Vol. 74, No. 80, Tuesday, April 28, 2009, page 19279.

[5] Michael A. Turner, Alyssa Lee, Robin Varghese and Patrick Walker, "Recovery, Renewal and Resiliency: Gulf Coast Small Businesses Two Years Later," Political and Economic Research Council and the Brookings Institution Urban Markets Initiative (August 2007).

[6] Certified Community Development Financial Institutions - Alphabetical By State and City, U.S. Treasury CDFI Fund, http://www.cdfifund.gov/docs/certification/cdfi/CDFIbyState.pdf and http://www.cdfifund.gov/docs/certification/cdfi/CDFIbyOrgType.pdf, accessed on May 7, 2008.

[7] *The CDFI Data Project Fiscal Year 2006*, Sixth Edition, http://opportunityfinance.net/store/downloads/cdp_fy2006.pdf, accessed on May 7, 2008.

[8] National Federation of Community Development Credit Union website, http://www.natfed.org/i4a/pages/index.cfm?pageid=1, accessed on May 7, 2008.